

**California Commission on Tax Policy
in the New Economy**

Newport Beach
November 17, 2003

Proceedings

NOVEMBER 17, 2003: NEWPORT BEACH

Welcome Remarks:

Commissioner Marilyn Brewer
Homer Bludau - City Manager

√Report on Meeting with the Transition Team's Tax Policy Group of Governor-Elect Schwarzenegger

Martha Jones, Ph.D. - California Research Bureau, California State Library
Marshall Graves - California Department of Technology, Trade and Commerce

Voting on Commission Recommendations

Discussion of Final Report

Martha Jones, Ph.D. - California Research Bureau, California State Library

Letter to Commission members from Assembly Member Ed Chavez, Chair, Assembly Committee on Revenue & Taxation November 13, 2003

Note: Documents concerning the tax court proposal are found in the Sept.9, 2003 meeting.
Documents concerning the DBS tax proposal are included in the May 22, 2003 meeting.

**MEETING OF THE
CALIFORNIA COMMISSION ON TAX POLICY IN THE NEW ECONOMY**

www.caneweconomy.ca.gov

Newport Beach City Council Chambers
3300 Newport Boulevard
November 17, 2003

DRAFT AGENDA

- 9:30 AM Chairman Bill Rosendahl
- Meeting called to order
Announcements
Roll Call and Introductions
- 9:45 AM Commissioner Marilyn Brewer
Newport Beach Mayor Steven Bromberg (invited)
- Welcoming Remarks
- 9:50 AM Chairman Bill Rosendahl
- Discussion of Final Report
- 12:30 PM Break for Lunch
- 1:15 PM Discussion of Final Report (continued)
- TBD Chairman Bill Rosendahl
Commissioners
- Concluding remarks / final comments
- Adjourn

Agendas for public bodies supported by the California Technology, Trade and Commerce Agency are available at <http://commerce.ca.gov>. For additional information regarding this notice, please contact Marshall Graves, California Technology, Trade and Commerce Agency, 1102 Q Street, Suite 6000, Sacramento, CA, 95814, (916) 445-7654, or email him at: mgraves@commerce.ca.gov.

To: Commissioners, Commission on Tax Policy in the New Economy
Craig Wilson, Office of Governor-Elect Schwarzenegger
From: Martha Jones, Ph.D., California Research Bureau
Re: Meeting with Transition Team Tax Policy Group
November 10, 2003

On November 4th, 2003, Marshall Graves and I met with the Tax Policy Group of Governor-Elect Schwarzenegger's transition team. Chairman Rosendahl participated by phone. I have attempted to accurately summarize the discussion, based on both my notes and Marshall's notes. If there are misrepresentations or omissions, please let me know.

Mr. Dean Andal outlined the broad objectives of the Tax Policy Group:

1. How to streamline our tax administration and make compliance easier.
2. How to improve our ability to promote and track jobs.
3. Long term restructuring of the tax system.

A general comment made by Mr. Andal was that there is the most consensus for tax reform in the area of efficiency. Why is our state tax system so complex and difficult? Complexity causes conflict. Mr. Andal cited a survey done annually by CFO magazine that ranks California last for tax administration and simplicity.

The following people attended the November 4th meeting:

Chairman Rosendahl (by phone)
Marshall Graves
Martha Jones, California Research Bureau

Dean Andal, Director, State and Local Tax Practice, KPMG
Larry McCarthy, President, California Taxpayers' Association
Greg Turner, California Taxpayers' Association
Jon Coupal, President, Howard Jarvis Taxpayers Association
The Honorable John Campbell, California State Assembly
Craig Wilson, Office of Governor-Elect Schwarzenegger

We informally discussed the attached PowerPoint presentation and went through each proposal for tax/budget reform. The discussion of the various tax/budget proposals is outlined below in red.

Sales Tax

1. PARTICIPATION IN THE STREAMLINED SALES TAX PROJECT

Proposal: Encourage the legislature to pass and the Governor to sign legislation authorizing California's participation as a voting member in the Streamlined Sales Tax Project (SSTP).

We discussed the composition of group that will vote at SSTP meetings (the Board of Governance). Information on this Board follows:

6027. (a) There is created in state government a Board of Governance consisting of two Members of the Senate chosen by the Senate Committee on Rules, one of whom shall belong to the majority party and one of whom shall belong to the minority party, two Members of the Assembly chosen by the Speaker of the Assembly, one of whom shall belong to the majority party and one of whom shall belong to the minority party, one member of the State Board of Equalization, one member of the Franchise Tax Board, and one member of the Governor's Department of Finance.

(b) The board may represent this state in all meetings, limited only to those states that are also authorized by statute to enter into the agreement. The board shall vote on behalf of this state and shall represent the position of this state in all matters relating to the adoption of or amendments to the agreement.

(c) The board shall report quarterly to the Assembly and Senate Revenue and Taxation Committees on the board's progress in negotiating the agreement and shall recommend to the committees the state statutes required to be added, amended, or otherwise modified for purposes of substantially complying with the agreement. 6028. The state's decision to join the Streamlined Sales Tax Project shall not invalidate, amend, or otherwise modify, in whole or in part, any provision of the law of this state. Implementation of any provision of the agreement in this state, whether adopted before, at, or after this state's adoption of the agreement, shall be exclusively done by a separate act or acts of the Legislature.

2. IMPROVE COLLECTION OF THE USE TAX ON REMOTE SALES

Proposal: Efforts should be made by the Board of Equalization to improve collection of the use tax that is currently California law.

Assemblymember Campbell commented that whatever changes are made, there's no enforcement or paper trail. Won't do too much good in terms of raising revenue.

3. BROADEN THE SALES TAX BASE TO INCLUDE SELECTED SERVICES AND REDUCE THE SALES TAX RATE

Proposal: Broaden the sales tax base to include selected services, while lowering the rate to retain revenue neutrality. The Commission has heard "Broaden the base and reduce the rate" frequently.

The highest revenues would come from taxing professional groups. People with most money would be paying for these services.

Regardless of the attempt to achieve revenue neutrality, this is a new tax. Transition team members did not seem receptive to the idea of new taxes. We need to improve California competitiveness. Statistics were cited concerning economic development in California. Every increase in the sales tax of one percentage point leads to a decrease of 20,000 to 30,000 jobs.

4. ELIMINATE SELECTED SALES AND USE TAX EXEMPTIONS OR EXCLUSIONS

Proposal: Eliminate selected sales and use tax exemptions or exclusions.

Eliminating the exemptions on prescription drugs, food and energy would bring in the most money.

How does the Commission propose to identify the exemptions to eliminate? How would regressivity be dealt with? Eliminating the exemption on food and prescription drugs would be regressive.

Comment: The proposal as written is not revenue neutral.

Telecommunications Taxes

5. STATEWIDE COMMUNICATIONS SIMPLIFICATION TAX

Proposal: Combine all state and local taxes, fees and surcharges charged on providers of electronic communications services (e.g. telephone companies, cellular companies, cable television companies, satellite companies) and their customers into one statewide tax on customers' communications bills. This statewide tax would be collected by distributors and allocated by the State Board of Equalization to state and local jurisdictions currently receiving revenues from existing taxes, fees and surcharges on a revenue-neutral basis, meaning that the total amount of revenue collected from all sources under the simplified tax would be essentially equivalent to the amount collected currently.

This issue is very important. California needs to take leadership and maybe the rest of the country will follow. Fold all surcharges into one or two taxes. One tax on communications and one tax on utilities. Then California would need a mechanism to distribute these funds.

Right now, on your phone bill, there are many earmarked fees. Phone bills are incomprehensible.

Dean Andal offered to provide language for this proposal.¹

6. DIRECT BROADCAST SATELLITE TAX

Proposal: Impose a statewide eight-percent tax on Direct Broadcast Satellite (“DBS”) service that approximates the tax and fee burden on cable television operators and subscribers.

Assemblymember Campbell commented that the whole system is undergoing such rapid technological change that we should wait a few years until the DBS/cable system matures before the tax system is changed. Everything is evolving... Consolidation of cable companies into one or two companies. Technologies are converging.

Satellite now has 1/3 of TV market share.

Property Tax

7. PROPERTY/SALES TAX SWAP

Proposal: Change the mix of local general-purpose revenue by decreasing the amount of sales tax revenue and replacing it with property tax revenue. The objective of this proposal is to decrease the reliance on the sales tax and increase the reliance on the property tax. To do so, the one percent locally levied sales tax rate would be reduced to ½ percent and replaced by an equal amount of property tax.

There was agreement that California needs to restore solvency to local governments, but Prop 13 is sacred. Assemblymember Campbell commented that there's a new variation on the swap in the works².

¹ Mr. Andal's recommendations for telecommunications taxes were published as “Taxation of Telecommunications and Energy in California,” *State Tax Notes*, March 18, 1996. This article was distributed to the Commissioners on December 5, 2003.

² One such variation on the property/sales tax swap was outlined in the *San Francisco Chronicle* on November 6, 2003. The proposal would have cities, counties, and special districts surrender 1 percent of the 3.75 percent of sales tax that goes into local coffers now. Local government no longer would receive at least \$4.2 billion from vehicle license fees. In return, they would receive an equivalent amount of property tax revenue that the state now uses to help support public schools. Cities and counties would be given the ability to increase local sales taxes – and keep that revenue – if local voters agreed. Currently, local governments must get authorization from the state before proposing a sales tax increase. For schools, the plan would replace the lost property tax money with the sales tax and vehicle license fee revenue surrendered by local governments. The minimum guarantee of support for schools from the state would be increased to 45 percent of the state's general fund. That minimum would rise by one-half of a percent each year for 6 years so that, by 2010, schools would be getting nearly half of each general fund dollar.

We briefly discussed the League of Cities new proposal...Local Taxpayers and Public Safety Protection Act.³

8. PERIODIC REASSESSMENT OF NON-RESIDENTIAL PROPERTY

Proposal: Distinguish between residential and non-residential property, and periodically re-assess non-residential property to market value.

We briefly discussed the California Teacher Association/Rob Reiner initiative:⁴

- *League of Cities opposed.*
- *This proposal would add disincentives to low-cost housing.*
- *Multi-family residential properties are included in the Teacher Initiative's definition of "non-residential." The Tax Policy Group suggested that the Tax Commission's proposal should make the definition of "non-residential property" explicit.*

The practical issue with periodic reassessment of non-residential property is that valuation methods for commercial property without a third party transaction give different estimates. For example, one can use a replacement value or an income-based value.

If assessment practices are changed in this way, it will be a negative signal to business.

Local Taxes

9. CONSTITUTIONALLY PROTECT LOCAL REVENUES

Proposal: Provide a constitutional minimum allocation of property taxes to local governments.

Assembly Member Campbell would link this proposal to the property/sales swap.

10. REDUCE THE VOTE THRESHOLD FOR LOCAL TAX MEASURES

Proposal: Reduce the vote threshold now required for approval of local special tax measures from two-thirds to 55 percent.

³ This proposal, for the November 2004 ballot, would prevent the state from reducing sales tax or property tax revenue to local government without voter approval. It would tighten a requirement that the state reimburse counties and cities for services they provide on the state's behalf.

[Hhttp://www.cacities.org/doc.asp?id=7725](http://www.cacities.org/doc.asp?id=7725)H

⁴ The initiative, which increases the tax rate on commercial property by 0.55 percent, will raise more than \$3 billion annually for K-12 schools and \$1.5 billion for preschools. It does not raise residential property tax rates or taxes for California homeowners. It excludes agricultural property, timberland and government property. And it provides personal property tax relief for small businesses. These funds would be used to fund K-12 education (teachers' salaries, smaller class sizes) as well as universal, voluntary preschool.

[Hhttp://www.cta.org/News/2003/20031029_1.htm](http://www.cta.org/News/2003/20031029_1.htm)H

No discussion of this proposal.

Other Tax Policy Options

11. STATE TAX COURT

Proposal: California should establish a state tax court to resolve all tax disputes, including personal income tax, corporate income tax, sales and use tax, property taxes, payroll taxes, and excise taxes.

Dean Andal took issue with the statement in the Options Report that “BOE aren’t trained as specialists.” He says historically many of those who run for the BOE positions have, in fact, been trained tax specialists. Assembly member Campbell said that this might have been true before, but with term limits, things are changing. Now, these seats are needed for termed-out legislators.

Andal was concerned that a tax court would be dominated by income tax lawyers who don’t know anything about sales and other taxes.

Campbell emphasized that the lack of written precedents, especially in the income tax area, is a big problem.

Andal suggested that rather than a tax court: (1) get rid of pay to play set-up and (2) improve the timing so it doesn’t take so long to get approvals or appeals.

Campbell asked whether there was any thought given to extending the state tax court to the regional or local level?

Andal suggested that the Attorney General should appoint tax lawyers to serve in each of 6 districts.

Andal said that currently, most superior court judges have criminal law backgrounds. We need superior court judges with tax backgrounds.

Andal: BOE currently hears about 1,000 appeals cases per year. 90% of these have no representation. Only 10% are successful. Only 2% are represented by lawyers.

Andal: He thinks it’s very important to get rid of the current pay-to-play rules. However, the state would need some sort of partial payment.

Chairman Rosendahl asked Martha to serve as a liaison between Commissioner Weintraub and the transition team. On the transition team, Dean Andal was particularly interested in this proposal. Chairman Rosendahl would like Commissioner Weintraub to speak with Dean Andal.

Coupal – concerned about tax court – Article 3 in the Constitution – Judicial power act. Would California need a constitutional amendment? Not sure if California could establish a tax court by legislation alone.

12. FLAT-RATE TAXES

Proposal: Eliminate all current taxes in California except for “sin taxes,” such as cigarette and alcohol taxes, and establish two new taxes, a six-percent flat-rate personal income tax and a six-percent flat-rate business value-added-tax.

Assembly member Campbell noted that this option is attractive but the main problem with the flat tax is political: winners are high income, losers are low income. A flat tax would be regressive.

Dean Andal suggested making state personal income tax a simple multiple of the federal income tax.

This proposal is a good candidate for further study.

APPENDIX A: PROPOSED STRUCTURAL REFORM OF THE STATE BUDGET PROCESS

1. Revise the current spending limit. *No discussion of this proposal.*
2. Reserve Requirement. *No discussion of this proposal.*
3. Rebalancing an unbalanced budget.

Andal: state employee unions have locked the state into multi-year contracts. In a deficit year, you can't limit obligations to current services. Andal thinks that future negotiations with labor unions should include a provision to renegotiate in deficit years.

Something has to be done about unemployment insurance. Some evidence of hundreds of millions of dollars of fraud that needs to be addressed.

4. Multi-year budget planning requirement. *No discussion of this proposal.*
5. Foster a “culture of accountability” in the budget process. *No discussion of this proposal.*

CALIFORNIA ADVOCATES, INC.



November 14, 2003

Mr. William J. Rosendahl, Chairman
California Commission on Tax Policy in the New Economy
1102 Q Street, Suite 6000
Sacramento, CA 95814

Dear Mr. Rosendahl:

Our firm represents the California Defense Counsel (hereinafter "CDC"), a statewide association of approximately 3000 lawyers specializing in representing defendants in civil litigation. We understand that the California Commission on Tax Policy in the New Economy will consider a proposal to establish a new California Tax Court at the Commission's November 17 meeting. We appreciate the opportunity to comment on the proposal.

CDC opposes the creation of a state tax court at this time. As you know, the California court system has undergone major changes and evolution in recent years, including the establishment of a state funding process, consolidation of municipal and superior courts, transfer of responsibility for facilities to the state, and other changes. The entire judicial branch is currently working diligently to implement these major reforms, and we see no justification for further burdening the system with the massive structural changes necessary to establish a separate tax court.

California also struggles with fundamental questions relating to properly funding the judicial branch and providing appropriate facilities for the public. We believe that these issues should be resolved prior to any serious consideration of devoting substantial resources to the establishment of a separate court system.

There are also important policy questions involved in a proposal which simultaneously fragments the existing state court system and shifts accountability away from the local level, if local property tax appeals were to be assigned to the state tax court system. CDC has traditionally opposed the creation of specialized business or tax courts, as confusing and ultimately detrimental to the existing judicial branch and we have seen no evidence warranting a change in our position at this time.

Mr. William J. Rosendahl, Chairman

California Commission on Tax Policy in the New Economy
November 14, 2003
Page 2

There are certainly profound policy questions surrounding tax policy in our new information-based economy, but we do not believe that establishment of a separate, tax-only court responds to these issue or is appropriate at this time. Thank you for considering our views.

Sincerely,

Michael D. Belote

MDB:cs

cc: Gene Wong, Chief Counsel, Senate Judiciary Committee
Drew Liebert, Chief Counsel, Assembly Judiciary Committee
Martin Helmke, Chief Consultant, Senate Revenue and Taxation Committee
Eileen Roush, Principal Consultant, Assembly Revenue and Taxation Committee
Dan Pone, Judicial Counsel
Raymond Coates, California Defense Counsel

November 12, 2003

Mr. William J. Rosendahl, Chairman
California Commission on Tax Policy in the New Economy
1102 Q Street, Suite 6000
Sacramento, CA 95814

Re: State Tax Court Option: OPPOSE

Dear Mr. Rosendahl:

The Consumer Attorneys of California (CAOC) appreciate the opportunity to comment upon the California Commission on Tax Policy in the New Economy's discussion regarding the creation a tax court, as a specialized forum for "resolving all tax disputes."

The Consumer Attorneys oppose the establishment of a separate tax court. It is our opinion that the existing court structure, is with its modern emphasis upon consolidation, is more than sufficient. Courts of General Jurisdiction through their adoption of common practices and procedures allow for the flexible and efficient use of judicial staff and facilities that best meet the demand of any increase in litigation within a given specialty of law. Additionally, a specialized tax court would set a precedent that would most probably result in requests for further fragmentation of the courts into specialized forums.

Under current law Californians have a "tax court" option: the Board of Equalization (BOE). The BOE in conjunction with the California Franchise Tax Board have settlement programs that permit taxpayers to pursue an administrative settlement process when seeking resolution of their tax disputes. The BOE and the Franchise Tax Board have qualified, professional staff available to the public. The existing structure is clear and most importantly provides for the public accountability of the BOE members. In contrast there is no public accountability provision in the tax court proposal.

At a time when budgetary constraints are of primary concern, any attempt to fragment the existing court system and to train and staff specialized courts with "tax law specialists" would be costly and time consuming. CAOC believes that the current judicial structure provides for cost effective, flexible responses to Californians' tax disputes.

For these reasons, the Consumer Attorneys of California oppose the establishment of a specialized tax court as recommended by the Commission. If you or your staff would like to discuss this matter further please contact me or one of our legislative advocates at our Sacramento Office.

Sincerely,

A handwritten signature in black ink, appearing to read "Bruce Brusavich".

Bruce Brusavich
President

November 6, 2003

Mr. William J. Rosendahl, Chairman
California Commission on Tax Policy in the New Economy
1102 Q Street, Suite 6000
Sacramento, California 95814

Subject: Opposition to State Tax Court Option

Dear Mr. Rosendahl:

We have reviewed the discussion by the California Commission on Tax Policy in the New Economy of the option of creating a tax court, and we appreciate the opportunity to comment on the proposal.

The Judicial Council opposes fragmentation of the court system, which would be the result of creating a new tax court or other specialty courts. The thrust of modern court administration has been to avoid such fragmentation, to consolidate courts, and to adopt common practices and procedures that permit efficient, flexible use of judicial staff and facilities. Courts of general jurisdiction can better meet demand, as the volume of litigation rises and falls within specific areas of the law.

Numerous legislative proposals have been introduced over the last 25 years to create tax courts, all of which have been unsuccessful. [See e.g., AB 1155 and ACA 38 (1979), AB 2254 and ACA 38 (1980), SB 2032 and SCA 51 (1984), SB 124 and SCA 6 (1989), SB 23 and SCA 25 (1992).] The Legislature has consistently rejected the creation of tax courts based on many of the same concerns expressed by the Judicial Council and others about the inappropriate balkanization of the court system, as well as the inefficient and costly nature of the proposals.

Past legislative proposals have included creating a separate five- or seven-judge tax court that would hold hearings throughout the state. [See e.g., SCA 6 (Garamendi) and SB 124 (Garamendi) of 1989, and SCA 25 (Kopp) and SB 23 (Kopp) of 1992.)] Each of these proposals would have required the appointment of judges who are certified tax specialists. The tax courts would also have included small claims divisions and would have heard tax-related cases exclusively. When these proposals were being considered, the Judicial Council estimated that the costs of operating these tax courts could range from \$6.5 to \$7.5 million for the five-judge court, and \$8.5 to \$9.5 million for the seven-judge court. The present-day costs of operating such tax courts would of course be considerably higher. The cost would also depend on the structure and makeup of the tax court, including the standard for review and other applicable procedures, which are not specified in the option the commission is considering.

While tax matters can present unique and complex problems, it is also true that complexity can occur in any type of litigation. The creation of a specialty tax court would set an inappropriate precedent since other equally valid arguments can be made for

separate probate courts, criminal courts, family law courts, personal injury courts, and so forth.

In addition, specialty courts are not necessary since the superior courts in each county can create separate departments or calendars within existing structures to deal with cases involving subjects such as tax, probate, product liability, personal injury, family, or criminal law. Under local rules, such specialization permits the judicial staff and court facilities to serve changing needs without inflexible constitutional or statutory mandates.

Furthermore, cases cannot be arbitrarily classified into segments dealing exclusively with one field of law. They do not divide neatly into tax, tort, contract, property, and other such categories. The field of tax law touches on a wide variety of legal fields, including probate, real property, divorce, and personal injury. Under the option being considered by the commission, a new state tax court would be established "to resolve all tax disputes, including personal income tax, corporate income tax, sales and use tax, property taxes, payroll taxes, and excise taxes." (Commission, "Options for Revising the California Tax System," June 15, 2003 draft, at p. 33.) The judges deciding such matters should not come from a specialized field that traditionally focuses primarily on matters related to the federal Internal Revenue Service.

For the above reasons, the Judicial Council opposes the creation of a specialty tax court and respectfully requests that the commission reject this option at its November 17, 2003, meeting. However, we would be pleased to meet with the proponents of this proposal and discuss how best to address the handling of tax cases in the courts. This could include possible rules changes, increased resource materials for judicial officers, improved calendaring and record-keeping systems and other case management enhancements to make the processing of tax cases as effective and efficient as possible. If you have any questions or need any additional information, please feel free to contact Daniel Pone, Senior Attorney in our Office of Governmental Affairs, at 916-323-3121.

Sincerely,

A handwritten signature in black ink, appearing to read 'W. Vickrey', with a stylized flourish extending to the right.

William C. Vickrey
Administrative Director of the Courts

WCV/DP/ml

cc: Martin Helmke, Chief Consultant, Senate Revenue & Taxation Committee
Drew Liebert, Chief Counsel, Assembly Judiciary Committee
Eileen Roush, Principal Consultant, Assembly Revenue & Taxation Committee
Fred Silva, Public Policy Institute of California
Gene Wong, Chief Counsel, Senate Judiciary Committee

DECEMBER 3, 2003

Slide 1

California Commission on
Tax Policy in the New Economy
www.caneweconcomy.ca.gov
Chairman Bill Rosendahl



Association of California Water Agencies
San Diego, California
December 3, 2003

1

Slide 2

Commission's Charter

- Established by SB1988 (Vasconcellos)
- Nine Commissioners, Nine Ex-Officio Members
- Address tax policy issues including, but not limited to:
 1. Sales and use tax
 2. Telecommunications taxes
 3. Income taxes
 4. Property taxes.
- Governor Gray Davis request on February 3, 2003:
Evaluate structural reforms for the California budget process

"Be an honest broker and a safe haven"

2

Slide 3

Commission History

- Seventeen hearings throughout the state
- *Interim Report*,
November 25, 2002
- *Options for Revising the California Tax System*,
June 15, 2003
- Last hearing on November 17, 2003
Discussion and voting on proposals in the *Options Report*
- Final Report due December 31, 2003

3

Slide 4

Options for Revising the California Tax System
June 15, 2003

Analyze twelve tax policy proposals using the following principles:

FAIRNESS and PERCEPTION: equity, transparency and visibility,
minimum tax gap, neutrality

SIMPLICITY: certainty, convenience of payment, economy of
collection, simplicity

EFFICIENCY/BALANCE: economic growth and efficiency,
appropriate government revenues

4

Slide 5

Commissioners' Discussions and Recommendations on November 17, 2003

1. Participate as a voting member in the Streamlined Sales Tax Project.
SB157 (Brown) authorized California to participate as a voting member.
No discussion : Issue decided.
2. Improve collection of the use tax on remote sales
Efforts should be made by the Board of Equalization to improve collection of the use tax that is currently California law.
SB1009 (Alpert) adds a line for the use tax on personal income tax forms.
Vote : Yes 9, No 0, Further Study 0

5

Slide 6

Commissioners' Discussions and Recommendations on November 17, 2003

3. Broaden the sales tax base to include selected services, while lowering the state rate to retain revenue neutrality.
PRO: Tax policy should reflect the change in California's economy as it shifts from sales of tangible goods to providing services.
CON: To avoid a sales tax on particular services, large firms could possibly bring outsourced services in-house, placing more of the tax burden on small businesses.
COMMENT: The importance of revenue neutrality was emphasized. This should not be considered as part of a two part process to increase the state sales tax rate at a later date.
Vote : Yes 8, No 0, Further Study 1

6

Slide 7

Commissioners' Discussions and Recommendations on November 17, 2003

4. Eliminate selected sales and use tax exemptions or exclusions.
COMMENT: There are nearly 150 exemptions and exclusions in effect, complicating collection and administration efforts. Further study is necessary to determine which exemptions and exclusions should be eliminated.
Vote : Yes 0, No 0, Further Study 9
5. Simplify communications taxes.
No discussion. By consensus opinion, the Commissioners deferred this proposal for further study on October 25, 2003.
6. Impose a tax on DBS (Direct Broadcast Satellite) services.
No discussion. By consensus opinion, the Commissioners deferred this proposal for further study on October 25, 2003.

7

Slide 8

Commissioners' Discussions and Recommendations on November 17, 2003

7. Property and sales tax swap.
Replace sales tax revenues with property tax revenues at the local level: this swap would reduce local government reliance on sales tax and big box retail. Encourages smart growth and investment in housing.
COMMENT: The Commissioners had concerns about the impact of the swap on financing education, police and fire. Whatever implementation plan is agreed upon by the Legislature, provisions for adequately financing education, police and fire must be included.
Vote : Yes 7, No 0, Further Study 2

8

Slide 9

Commissioners' Discussions and Recommendations on November 17, 2003

8. Periodic reassessment of non-residential property.

In the context of improving the business climate in California, periodically reassess non-residential property to market value without changing existing tax rates.

COMMENT: Distinguish between residential and non-residential property. Non-residential property is defined to include commercial and industrial property, but does not include multi-family residential.

COMMENT: Commissioners voting "No" thought this change would hurt the business climate.

Vote: Yes 0, No 3, Further Study 6

9

Slide 10

Commissioners' Discussions and Recommendations on November 17, 2003

9. Constitutionally protect local revenues.

Provide a constitutional minimum allocation of property taxes to local governments.

COMMENT: Concerns were raised about how education financing would fit with this proposal.

Vote: Yes 8, No 1, Further Study 0

10. Reduce the vote threshold for local tax measures.

Reduce the vote threshold now required for approval of local special tax measures from two-thirds to 55%.

COMMENT: Commissioners voting "No" thought that reducing the vote threshold would make it too easy to raise local taxes.

Vote: Yes 6, No 3, Further Study 0

10

Slide 11

Commissioners' Discussions and Recommendations on November 17, 2003

11. Establish a state tax court.

California should establish a state administrative body to operate like the U.S. Tax Court. The administrative body would resolve all tax disputes, including personal income taxes, corporate income taxes, sales and use taxes, property taxes, payroll taxes, and excise taxes in accordance with the principles set forth in Professor Simmons' September 23, 2003 letter to the Commission.

COMMENT: This proposes an administrative body, not a specialized tax court.

Vote: Yes 9, No 0, Further Study 0

12. Establish a flat rate tax system.

Eliminate all current taxes in California except for "sin taxes," such as cigarette and alcohol taxes, and establish two new taxes, a six percent flat-rate personal income tax and a six-percent flat-rate value-added tax.

COMMENT: The Commissioners were concerned with the regressivity of flat taxes.

Vote: Yes 0, No 2, Further Study 7

11

Slide 12

Commissioners' Discussions and Recommendations on Budget Structural Reform Proposals November 17, 2003

Budget structural reform proposals were discussed and voted on as a group:

1. Revise the current spending limit.
In order to make the spending limit more transparent, revise it to limit spending based on the prior year level, adjusted for population growth and economic growth.
2. Reserve Requirement.
In order to reduce the fiscal shock of economic downturn, require the maintenance of a reserve.
3. Rebalancing an unbalanced budget.
Establish a system for rebalancing the state budget when it becomes unbalanced.
4. Multi-year budget planning requirement.
Initiate a fiscal planning requirement that will require the state budget process to plan longer than 12 months.
5. Budget Accountability.
Implement changes that would foster a culture of accountability in the budget process.

Vote: Yes 9, No 0, Further Study 0

12

Slide 13

Commissioner Voting Summary			
Yes	No	Further Study	Proposal
SB 157 Approved			1. Participate as a voting member in the Streamlined Sales Tax Project.
9	0	0	2. Improve collection of the use tax on remote sales.
8	0	1	3. Broaden the sales tax base to include selected services, while lowering the state rate to retain revenue neutrality.
0	0	9	4. Eliminate selected sales and use tax exemptions or exclusions.
0	0	9	5. Simplify communications taxes. <small>NOTE: Consensus opinion from October 23, 2003</small>
0	0	9	6. Impose a tax on DBS (Direct Broadcast Satellite) services. <small>NOTE: Consensus opinion from October 23, 2003</small>
7	0	2	7. Property and sales tax swap.

13

Slide 14

Commissioner Voting Summary			
Yes	No	Further Study	Proposal
0	8	6	8. Periodic reassessment of non-residential property.
8	0	1	9. Constitutionally protect local revenues.
6	8	0	10. Reduce the vote threshold for local tax measures.
9	0	0	11. Reestablish a state tax court.
0	2	7	12. Reestablish a flat rate tax system.
9	0	0	13. Budget structural reform (5 proposals).

14

Slide 15

Visit the Commission's website at

www.caneweeconomy.ca.gov

15

¹ California Governance Consensus Project, Executive Summary www.csus.edu/calst/cgcp/page1.htm

¹ California Governance Consensus Project. "Conceptual Plan as Modified at the March 2, 1999 Plenary Meeting. <http://www.csus.edu/calst/cgcp/page2a.htm>

¹ This discussion relies heavily on J. Fred Silva and Paul G. Lewis, *Changing the Order of Things: Six Proposals for Local Finance Reform*. Prepared for the Conference on Local Finance Reform, Davis California.

Commission Votes on the Recommendations

Sales Tax

	Yes	No	Further Study	Abstain
Efforts should be made by the Board of Equalization to improve collection of the use tax that is currently California law.	9	0	0	0
Broaden the sales tax base to include selected services, while lowering the state rate to retain revenue neutrality.	8	0	1	0
Eliminate selected sales and use tax exemptions or exclusions.	0	0	9	0

Property Tax

	Yes	No	Further Study	Abstain
Property/Sales Tax Swap: Change the mix of local general-purpose revenue by decreasing the amount of sales tax revenue and replacing it with property tax revenue. The objective of this proposal is to decrease the reliance on the sales tax and increase the reliance on the property tax.	7	0	2	0
In the context of improving the business climate in California, periodically re-assess non-residential property to market value without changing existing tax rates.	0	3	6	0

Local Taxes

	Yes	No	Further Study	Abstain
Provide a constitutional minimum allocation of property taxes to local governments.	8	0	1	0
Reduce the vote threshold now required for approval of local special tax measures from two-thirds to 55 percent.	6	3	0	0

Other Tax Policy Options

	Yes	No	Further Study	Abstain
State Tax Court: California should establish a state administrative body to operate like the U.S. tax court. This body would resolve all tax disputes, including personal income tax, corporate income tax, sales and use tax, property taxes, payroll taxes, and excise taxes in accordance with the principles set forth in Professor Simmons' September 23, 2003 letter to the Commission.	9	0	0	0
Flat-Rate Taxes: Eliminate all current taxes in California except for "sin taxes," such as cigarette and alcohol taxes, and establish two new taxes, a six-percent flat-rate personal income tax and a six-percent flat-rate business value-added-tax.	0	2	7	0

State Budget Process

	Yes	No	Further Study	Abstain
<ol style="list-style-type: none"> 1) Revise the current spending limit - In order to make the spending limit more transparent, revise it to limit spending based on population and economic growth. 2) Reserve requirement - In order to reduce the fiscal shock of economic downturn, require the maintenance of a reserve. 3) Rebalancing an unbalanced budget - Establish a system for rebalancing the state budget when it becomes unbalanced. 4) Multi-year budget planning requirement - Initiate a fiscal planning requirement that will require the state budget process to plan longer than 12 months. 5. Implement changes that would foster a "culture of accountability" in the budget process.⁵ 	9	0	0	0

⁵ As per the recommendations from the Bay Area Council and the Speaker's Commission on State and Local Government Financing.

MEMBERS
MARK WYLAND, VICE-CHAIR
TOM HARMAN
JOHN LAIRD
MARK LENO
JOE SIMITIAN
DEMOCRATIC VACANCY



STAFF
KIMBERLY MITCHELL BOTT
Chief Consultant
EILEEN A ROUSH
Principal Consultant
CHRISTINE HIERSCHE
Committee Secretary
STATE CAPITOL
P.O. BOX 942849
SACRAMENTO, CA 94249-0114
(916) 319-2098

Assembly Committee on Revenue and Taxation
ED CHAVEZ, CHAIR

November 13, 2003

California Commission on Tax Policy in the New Economy
1102 Q Street, Suite 6000
Sacramento, California 95814

Dear Commission Members:

I write in appreciation and support of your efforts, individually and collectively, as members of the California Commission on Tax Policy in the New Economy. The charge accepted in January 2002 has taken the Commission through review of a myriad of tax options in order to provide the Legislature with your recommendations on how to improve California's tax programs.

I recognize the great task that remains before you in completing the Final Report, both in identifying the topics to be included in the Final Report as well as preparing the Final Report.

The Commission's effort to improve our current system of taxation is outstanding. Again, I offer the services of my Committee staff to assist you as needed.

Sincerely,

A handwritten signature in blue ink, appearing to read "Ed Chavez", written over a horizontal line.

ED CHAVEZ
Assemblyman, 57th District
Chair, Assembly Committee on Revenue and Taxation

Scoring of Selected California Taxes*

Prepared by the Tax Policy Group
Of Joint Venture: Silicon Valley Network
<http://www.jointventure.org/tax/>

For the California Commission on
Tax Policy in the New Economy

November 2003

*Personal Income Tax
Sales and Use Tax
Property Tax
Utility User Tax
Bank and Corporate Franchise Tax

Table of Contents

Background on the Preparation of this Report		3
Tax Analysis:		
Type of Tax	Scoring	Background Information on the Tax
Personal Income Tax	4	21
Sales and Use Tax	7	26
Property Tax	12	30
Telecom Taxes - Utility User Tax	15	36
Corporate Income and Franchise Tax	17	38

Note: The background information for each tax analyzed is provided at the end of the report so as not to distract from the scoring for each tax. The background serves as a reference to support the scoring and to help in developing ways to improve the tax.

Joint Venture: Silicon Valley Network (www.jointventure.org) is a regional, non-partisan voice and a civic catalyst for solutions to problems, which impact all sectors of the community. Joint Venture brings together established and emerging leaders from business, labor, government, education, and community organizations. It also involves citizens in the region and is a neutral forum for new ideas and creative solutions. Real benefits for people, business, and community organizations are its goals.

Joint Venture's Tax Policy Group consists of individuals from high tech industry, government, and academia who analyze various state and federal tax rules and proposals to consider the impact to local governments and high tech industries. The Group's current work encompasses international tax reform, worker classification, R&D incentives, major federal tax reform, incentives for donations of technology to K-14, and sales tax issues of electronic commerce. The Group works to promote better understanding of tax and fiscal issues of significance to the Silicon Valley economy through distribution of its reports, sponsorship of seminars and discussion forums, and submission of testimony to legislators and tax administrators.

For copies of the Tax Policy Group's publications visit:

<http://www.jointventure.org/tax/>

Comments: Send to anellen@sjsu.edu

Background on the Preparation of This Report

In February 2003, Joint Venture's Tax Policy Group published a workbook containing a tool to help policymakers and others analyze existing tax and fiscal structures and proposals to determine how well they satisfy the basic principles of good tax policy. The analysis requires the user to consider the purpose of the tax or proposal, how it works, its degree of fairness, and whether it will operate efficiently. The analysis points out where there are plusses and minuses (areas for improvement) in the item being analyzed.

The analysis also helps to stimulate debate and discussion on the finer points of tax proposals and alternatives. This leads to a deeper understanding of tax and fiscal systems and issues.

Joint Venture's Tax Policy Group used the American Institute of Certified Public Accountants' (AICPA) tax policy statement to create the tool. The AICPA's statement—*Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*,⁶ provides ten principles for determining if an existing tax or a proposal to modify a tax rule follows good tax policy. The framework recognizes that it is not always possible to incorporate all ten principles into tax systems – that some balancing is needed.

The workbook created by Joint Venture to help policymakers and others evaluate plusses and minuses in either existing taxes or proposals to change existing tax rules regroups the AICPA's principles within three broad categories:

1. Fairness
2. Operability
3. Appropriate Purpose and Goals.

Joint Venture's Tax Policy Group was encouraged by members of the California Commission on Tax Policy in the New Economy to use the ten principles framework to analyze California's key taxes. This work was aided by a presentation by Annette Nellen, chair of the Tax Policy Group to the Commission on July 18, 2003 where questions were raised by the Commissioners, and a forum held by the Tax Policy Group on October 1, 2003 to obtain input from tax directors, CPAs, local government finance and policy directors and others.⁷

For more information about the workbook and the principles of good tax policy, see:

<http://www.jointventure.org/taxpolicyworkbook/index.html>

⁶ AICPA Tax Policy Statement No. 1 - Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals, 2001; available at <http://ftp.aicpa.org/public/download/members/div/tax/3-01.pdf>. Joint Venture extends its gratitude to the AICPA for granting Joint Venture permission to use Tax Policy Statement No. 1.

⁷ Joint Venture's Tax Policy Group acknowledges and thanks the following individuals for their contributions to the creation of this report: Bill Barrett, Lisa Bruner, Rebecca Elliott, David Ginsborg, Marshall Graves, Bill Harris, Linda Holroyd, Jeremy Joseph, Jim Joyce, Caroline Judy, Brian Moura, John Murphy, Annette Nellen, Dennis Ondyak, Jim Regan, Pete Rincon, Alan Schultz, Connie Verceles, Dat Vu, Ellen Wheeler, and Marguerite Wilbur.

APPLICATION OF THE GUIDING PRINCIPLES OF GOOD TAX POLICY: CALIFORNIA PERSONAL INCOME TAX (PIT)

Scoring

- + works well
- 0 needs improvement

Principle	Application and Analysis	Rating
Fairness		
Equity and Fairness Similarly situated taxpayers should be taxed similarly.	<p>As with the federal income tax, “ability to pay” is defined by a set of personal exemptions and deductions that might not truly tie to a person’s “ability to pay.” For example, a person may be paying medical expenses for a person who does not qualify to allow the payer to deduct the expenses whereas another person with the same income and medical expenses pays them for a qualified person. In addition, two investors with similar income will not pay the same tax to the extent one has investments in tax-exempt bonds while the other is invested in taxable investments. However, it is generally thought that the mix of deductions, exemptions and credits provides results in individuals with similar incomes paying similar amounts of tax.</p> <p>The PIT is very progressive in that many low to middle income individuals pay little or no PIT while those with higher incomes pay a significant amount of the total PIT collected. Strong arguments can be made that the PIT is too progressive by having so much of the tax paid by a small number of high-income individuals. In addition, the maximum PIT tax rates are high relative to other states.</p> <p>While California has the highest threshold for when PIT is owed, the mix of taxes must be considered to determine if the system as a whole is “fair.”</p>	0
Transparency and Visibility Taxpayers should know that a tax exists and how and when it is imposed upon them and others.	Californians pay the PIT either through withholding or estimated tax payments. Thus, individuals are generally aware that the PIT is being assessed or is due. While some phase-outs and the California Alternate Minimum Tax (AMT) may make it difficult to easily compute the PIT on a transaction, it is possible to do so.	+
Operability		
Certainty The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.	Generally, the PIT is certain. There are well-established regulations and case law to help interpret the PIT statute. Yet, complexity of transactions can lead to uncertainty for some transactions. Generally, though, this is the same uncertainty that individuals encounter under the federal income tax system.	+

<p>Convenience of Payment A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.</p>	<p>As most PIT is paid through withholding or quarterly estimated payments, payment is fairly convenient.</p> <p>Taxpayers who find a need to challenge a Franchise Tax Board (FTB) audit decision beyond the State Board of Equalization (SBE) appeal must pay the disputed liability before filing in Superior Court and may therefore find this route infeasible.</p>	<p>+</p>
<p>Economy in Collection The costs to collect a tax should be kept to a minimum for both the government and taxpayers.</p>	<p>The concentration of revenue in relatively few returns and the expansion of e-filing amongst lower-income taxpayers makes the California PIT fairly efficient for the government to collect. Information sharing agreements with the federal government provide a great audit tool for the Franchise Tax Board.</p> <p>The expansion of e-filing, and the high filing threshold will continue to address taxpayer compliance costs; moreover, the relatively high level of conformity to federal tax law makes the PIT a reasonable one with which to comply.</p>	<p>+</p>
<p>Simplicity The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.</p>	<p>The PIT is far from simple, although the complexity of the law most likely increases with the sophistication of the taxpayer. Much of the complexity stems from the federal income tax system upon which much of the PIT is based. Areas where California does not conform to the federal rules add to complexity in that taxpayers must spend more time with both compliance and recordkeeping.</p> <p>The fact that 63% of individuals must file the long form (Form 540) rather than the somewhat easier Forms 540A and 540EZ, is another indication of some complexity.</p> <p>A PIT based solely on the federal income tax paid would certainly be simpler.</p>	<p>0</p>
<p>Minimum Tax Gap A tax should be structured to minimize non-compliance.</p>	<p>There is a great deal of debate about the size of the PIT “tax gap.” Much of the focus has been on the problem of cash payments, particularly in some types of businesses.</p> <p>The California tax gap likely isn’t too much different than that for the federal income tax system. The IRS estimates that the amount of taxes not voluntarily paid is about 17% of total federal income taxes each year (83% compliance rate). IRS enforcement efforts eventually raise the compliance rate to about 87% each tax year. [GAO, <i>Reducing The Tax Gap - Results of a GAO-Sponsored Symposium</i>, GAO/GGD-95-157, June 1995, pages 2-3.]</p>	<p>0</p>
<p>Appropriate Government Revenues The tax system should enable the government to determine how much tax revenue will likely be collected and when.</p>	<p>Much has been said about the revenue “bubble” caused by stock options and capital gains in the past few years, and that this was caused by the growing reliance on high-wealth taxpayers to pay the bulk of the PIT. The short-term, “one-time” nature of the phenomenon was well-documented, and warnings went out from the FTB and the Legislative Analyst that the rate of growth of the PIT would not be sustained at that high level. In short, the PIT has been “unpredictable” and “volatile” in the sense of moving up and down drastically and unpredictably. Certainly, to the degree the PIT continues to concentrate on high-income taxpayers with fluctuating incomes, the potential for volatility will continue. With the PIT being primarily generated by a small number of taxpayers, it is affected more significantly (both positively and negatively) when there are changes in the incomes of this small group of taxpayers.</p>	<p>0</p>

	<p>Unlike the sales and use tax, the personal income tax is deductible for individuals who itemize their deductions on their federal income tax return. For some taxpayers, this deduction is reduced due to the federal alternative minimum tax. Thus, the state is able to shift some of this tax burden to the federal government.</p> <p>While lack of complete conformity with the federal income tax rules creates complexity, an advantage is greater ability for the state to control its revenues. However, revenue adjustments could instead be made by changing the tax rates, rather than making the tax base have less conformity to the federal income tax base.</p>	
Appropriate Purpose and Goals		
<p>Neutrality The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.</p>	<p>The income tax system has many provisions designed to encourage or discourage certain activities. For example, the PIT allows individuals who itemize to deduct charitable contributions. Favorable depreciation rules are designed to encourage capital investment.</p> <p>High tax rates may lead individuals who do not need to work or live in California to move to a lower tax state. The high tax rates can also lead entrepreneurs to start a business outside of California.</p>	0
<p>Economic Growth and Efficiency The tax system should not impede or reduce the productive capacity of the economy.</p>	<p>As a greater percentage of the PIT is borne by fewer and fewer high-wealth taxpayers, a fear arises that the PIT could drive some of these taxpayers to move to low- or no-income- tax states. These taxpayers are often the most productive and innovative in the economy. Moreover, to the degree that any such departures also result in a decline in California investment, future economic expansion is compromised.</p> <p>Relative to other states, California's tax rates are high. This, though, needs to be weighed in relation to other types of taxes, use of appropriate tax credits, and how the overall tax burden is distributed across income levels.</p> <p>While the PIT is very progressive, consideration should be given as to whether it offsets the regressivity of the sales tax.⁸ Or, should the sales tax be made more progressive (such as by taxing the types of consumption that higher income individuals tend to have such as services) and the income tax less progressive.</p> <p>To help align the goals of cities/counties and the state, consideration should be given to sharing the income tax with local governments, as is done in Arizona. Such an approach could better incentivize both levels of government to attract high wage jobs to California and provide them with the infrastructure (such as housing) that they would need.</p> <p>Consideration needs to be given to what the possible economic disadvantage is to California when it does not conform to a federal provision designed to provide an incentive to individuals, such as lower capital gains rates.</p>	0

⁸ A tax is progressive if it represents a higher percentage of a high-income taxpayer's income relative to the percentage it represents of a low-income taxpayer's income. A tax is regressive if it represents a higher percentage of a low-income taxpayer's income relative to the percentage it represents of a high-income taxpayer's income.

APPLICATION OF THE GUIDING PRINCIPLES OF GOOD TAX POLICY: CALIFORNIA SALES & USE TAX (SUT)

Scoring

+ works well

0 needs improvement

Principle	Application and Analysis	Rating
Fairness		
Equity and Fairness Similarly situated taxpayers should be taxed similarly.	<p>All California taxpayers pay SUT at the same rate (with slight variations by county), making it appear to be “fair.” However, the tax is regressive because consumption of tangible personal property (and thus the amount of SUT paid) represents a higher percentage of a low-income person’s income relative to a higher income person.⁹</p> <p>The California SUT was originally intended to do what it still does today – tax purchases of tangible personal property. It was not created decades ago to tax <i>all</i> consumption. However, over the past several years, consumption of services has increased while consumption of goods has declined. For taxpayers who consume a lot of services, they will not proportionately pay as much SUT on their consumption as would someone who has a high consumption of goods.</p> <p>The California SUT does not apply to intangible goods, such as software delivered via the Internet, but does apply to the tangible equivalent, such as off-the-shelf software purchased at an electronics store. Thus, where one person downloads the software and manuals, while another person purchases the same software on a diskette or CD, the first person pays no sales tax and the second one does even though each ends up with the same software.</p> <p>A use tax complements a state’s sales tax and is imposed at the same rate. A use tax generally applies when a taxpayer buys a taxable item outside the state for use inside the state. For example, when a resident buys a book from a remote (non-present) vendor, the resident is responsible for submitting the use tax to the state taxing agency. California has made no meaningful effort to collect the use tax from individuals (note, most businesses are use- tax compliant). The tax is mentioned in the instructions to Form 540, but not where people would likely see it, and many people today don't get the instructions because they use a software package to prepare their return. The State Board of Equalization (SBE) released Publication 79B a few years ago that explains the use tax and includes a form for calculating and remitting it. However, this publication is not sent to individuals. Several states try to collect the use tax by including a line item on the state income tax form (such as Maine, Michigan and North Carolina). Failure or inability to collect use tax from consumers on mail or Internet ordered tangible goods raises two equity issues:</p> <ol style="list-style-type: none"> 1. A consumer purchasing a tangible item, such as a computer, via the 	0

⁹ The degree of regressivity of the sales and use tax is not clear due to significant consumption exemptions in the system that benefit both low and high income individuals, such as housing and health care.

	<p>vendor's web site where the vendor has no physical presence in California, will not be charged sales tax, but owes use tax.¹⁰ If the tax is not paid, the consumer has not been treated similarly to a consumer who purchases a computer from a vendor located in California.</p> <p>2. Main street vendors are concerned that because they must charge sales tax to customers who purchase goods within their stores, while remote vendors selling the same items online or by mail order do not have to charge the tax. The vendors are not being treated similarly.</p> <p>Note: SB 1009 (Chapter 718) enacted in October 2003 will add a use tax line to the California personal income tax form. The FTB will remit the collected tax to the SBE.</p> <p>The California SUT is also flawed in that businesses also pay the tax on tangible personal property other than those that will be resold or incorporated into manufactured items to be sold (raw materials). SUT paid by businesses is then built into the cost of the goods they sell and consumers, in essence, pay a tax on a tax. This is referred to as a cascading or pyramiding effect. Cascading affects industries differently depending on the amount of taxable purchases a business makes, thereby violating the equity principle.</p> <p>While the Streamlined Sales and Use Tax Agreement (SSUTA) should provide uniformity in tax compliance, thus benefiting multistate vendors, it may also present some new complications for businesses and may lead to winners and losers among local jurisdictions if the point of sale is changed from origin to destination. The effect of the SSUTA on California businesses and local jurisdictions needs to be reviewed.</p>	
--	--	--

¹⁰ The 1992 U.S. Supreme Court decision in *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992), held that a state may not impose sales and use tax collection obligations on sellers who do not have a physical presence in the state. The Court modified its earlier ruling in *National Bellas Hess, Inc. v. Dept. of Rev.*, 386 U.S. 756 (1967), by ruling that a physical presence was no longer needed under the Due Process Clause. North Dakota had challenged the 1967 ruling as being out of date with today's ways of conducting business. Today, a company doesn't need a salesperson in a state to obtain a sale. Instead, a catalog and a mail-order sales system can be just as successful for a company. The Court agreed that conducting business in the state was sufficient to satisfy the Due Process Clause to allow a state to subject the vendor to taxation. However, the Court ruled that physical presence is still necessary under the Commerce Clause in order for a state to impose sales tax collection obligations on a remote (non-present) vendor.

Transparency and Visibility Taxpayers should know that a tax exists and how and when it is imposed upon them and others.	Sales and use taxes are visible because they are shown on the customer's invoice. Even invoices prepared at Internet sites will show any sales tax charged. However, many consumers may not know that a use tax exists on particular transactions. For example, many consumers who are not charged sales tax on online sales likely believe it is due to the Internet Tax Freedom Act moratorium ¹¹ when it is most likely due to the <i>Quill</i> decision. ¹² Also, customers likely don't know all that the sales and use tax applies to – for example, will it apply to “free” items obtained from online vendors? Does it apply to shipping charges?	0
Operability		
Certainty The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.	For the most part, the rules and tax forms are fairly clear. However, issues can arise as to whether a vendor has nexus (physical presence) in California and is thus obligated to collect SUT.	0
Convenience of Payment A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.	Vendors selling taxable items should collect the sales tax at time of payment, which is convenient for the buyer. Where a use tax is owed, to be paid by the buyer, payment is due at a later date. Payment of use tax by individual consumers is inconvenient: it requires that they maintain a list of purchases for which SUT was not collected and which items and charges are subject to SUT.	+
Economy in Collection The costs to collect a tax should be kept to a minimum for both the government and taxpayers.	Because the sales tax is collected by vendors, there is economy of collection. Because the use tax is paid by buyers, costs of collecting use tax, particularly from consumers, are high. The costs to collect the sales tax are heavily borne by vendors. Some states compensate vendors for a portion of these costs. Such a compensation system should be considered in any sales and use tax reform in California. Given the various reports in the past calling for elimination of the SBE and the economies of scale that might be achieved with a single state tax agency, these recommendations should be considered.	0
Simplicity The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.	Generally, within a single state, the SUT is fairly simple in that efforts have been made through legislation, regulations and rulings to identify the tax base. In many states, including California, the tax rate can vary from county to county and it may not always be clear in which county a taxpayer is located. From a multistate perspective, vendors face a myriad of tax bases and rates. In a few states, such as Colorado, the state and local SUT bases may vary. In the 1992 <i>Quill</i> decision (discussed earlier), the Court noted that there are over 7,500 jurisdictions in the U.S. imposing an SUT with varying bases, rates and filing procedures, which	0

¹¹ The Internet Tax Freedom Act, enacted in 1998, prohibits certain state and local taxes on Internet access, unless the tax was generally imposed and actually enforced before October 1, 1998. The moratorium also prohibits state and local governments from imposing *multiple* or *discriminatory* taxes on e-commerce. The moratorium was originally created by the Internet Tax Freedom Act, which imposed a 3-year moratorium (from 10/1/98 through 10/21/2001) [Public Law 105-277, 10/21/98]. This moratorium was extended to November 1, 2003 by Public Law No. 107-75 (enacted 11/28/01).

¹² See explanation of *Quill* decision at earlier footnote.

	poses complications for vendors. Thus, multistate vendors face additional complexities.	
Minimum Tax Gap A tax should be structured to minimize non-compliance.	The use tax causes a tax gap because so few consumers (and even some businesses) know what a use tax is or that it exists to complement the sales tax. While some states have made efforts to inform residents about the use tax, such as by adding a line on the state personal income tax form for it, as evidenced by the GAO report released in 2000 (discussed earlier), compliance is very low. Improvement could be made by states educating consumers about the use tax and simplifying compliance; simplifying sales tax systems such that Congress might exercise its authority under the Commerce Clause and allow states to collect use tax from remote vendors; or, replacing the sales tax with another type of consumption tax. The Internet not only makes it easier to purchase items from a vendor in another state, but also in another country. While Congress could require a remote vendor to collect a state's sales and use taxes, it will be far more difficult, to get a vendor in a foreign country to collect a state's sales tax. Thus, if the tax is to be collected, states will need to get consumers to voluntarily comply or to exempt foreign sales, which would violate the neutrality principle. An alternative consumption tax to the sales tax would be for consumers to measure their consumption as Income less Savings. Of course, this would also involve extra recordkeeping and it would broaden the consumption tax base over what it is today (it would tax all consumption rather than just tangible personal property).	0
Appropriate Government Revenues The tax system should enable the government to determine how much tax revenue will likely be collected and when.	<p>Tax agencies should be able to derive reasonable estimates of sales and use tax collections based on prior years' data and consumption data. However, declines due to increased on-line purchases from remote vendors (for which use tax may not get collected), and a shrinking base of consumption subject to California sales tax may lead to less reliability of the sales tax for California jurisdictions.</p> <p>Individuals may not treat sales and use tax as an itemized deduction on their federal income tax returns, in contrast to property and income taxes which are deductible. Thus, there is a greater cost of the SUT although many individuals do not itemize their deductions.</p> <p>The sales tax base is shrinking due to the fact that it primarily only includes consumption of tangible personal property and excludes services and intangibles. Also, the increased ability for consumers to purchase from remote vendors via the Internet shifts more of the SUT from a sales tax collected by vendors to a use tax owed by consumers, most of whom don't know that the use tax exists.</p>	0

Appropriate Purpose and Goals		
Neutrality The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.	The current situation where remote (non-present) vendors are not required to collect sales tax can cause sales tax to play a part in a customer's decision as to how and where to purchase goods and services. For example, a customer may decide to purchase a computer online to avoid sales tax rather than purchase the computer from a Main Street vendor. Also, in a few states, such as California, software (and other digitized goods) transferred online are not subject to sales tax, while their tangible counterpart (that is, a boxed music CD or software) is subject to sales tax. Thus, the sales tax law is not neutral in that it will play a role in a customer's decision as to how and where to purchase certain products.	0
Economic Growth and Efficiency The tax system should not impede or reduce the productive capacity of the economy.	<p>Cities in California have become more and more dependent on the sales tax for revenues over the past several years. This is due to restrictions upon local governments to raise revenues (such as Proposition 218, approved by the voters in 1996). This has led to a phenomenon referred to as <i>fiscalization of land use</i>, which means that the focus of decisions on how to best use land is driven more by the tax revenues to be generated than by how the land can best serve the needs of the community. While a city needs a majority vote of its citizens to raise the sales tax (or other tax) rate, it could instead have a large retailer or industrial sales office locate within its borders to generate sales tax revenues.</p> <p>Regulation 1802 encourages cities to entice manufacturers to locate a sales office within its borders, particularly where customers are located outside of the borders.</p> <p>Because the sales tax base does not include digitized items (intangibles), when software vendors switch from selling software on CDs or diskettes to transferring the software electronically, the cities that house the sales offices for such vendors are seeing a drop in sales tax revenues.</p> <p>Finally, due to the increase in consumption of services, rather than tangible goods, cities continue to see a drop in sales tax and a base that becomes more regressive, which adversely impacts lower income residents.</p>	0

APPLICATION OF THE GUIDING PRINCIPLES OF GOOD TAX POLICY: CALIFORNIA PROPERTY TAX

Scoring

- + works well
- 0 needs improvement

Principle	Application and Analysis	Rating
Fairness		
Equity and Fairness Similarly situated taxpayers should be taxed similarly.	<p>Some owners of owner-occupied property view the property tax system as unfair because newcomers to a neighborhood pay more property taxes than their neighbors who arrived earlier, although the properties have the same value (the "welcome stranger" characteristic). These newcomers use the principle of horizontal equity to argue for taxing all similarly valued property at the same amount—that is, those similarly situated should pay the same amount of tax. But, others argue that the property owners are not similarly situated because some individuals living in homes with a low-assessed value could not afford to purchase their home at its current value and, thus would argue that they are not similarly situated income-wise to newcomers who can afford to buy the home at its current market value.</p> <p>A new business that purchases real property (rather than lease it) will also view the system as unfair because its property taxes will be higher than those of a local competitor who has owned real property for a longer time. This puts the new business at a competitive disadvantage. Of course, not all new businesses purchase the real property needed for their business. When a new business leases the property, the property tax disadvantage may not exist, depending on how long the owner/lessor has owned the property. It is likely that most new businesses lease their real property. Also, businesses that own real property may sell it for business reasons and any new real property purchased would be assessed at the current market value (purchase price).</p> <p>The exclusion from reassessment available for sale of a principal residence between parents and children provides a benefit to such a buyer that other buyers are not able to obtain. Such benefits result in similar taxpayers not being treated similarly.</p>	0
Transparency and Visibility Taxpayers should know that a tax exists and how and when it is imposed upon them and others.	<p>Owners of real property are aware of property taxes and can easily find out the amount of property taxes that will be assessed on new property. Businesses are generally aware of business personal property taxes on equipment.</p> <p>When real property changes hands during the tax year, the new owner will receive "supplemental" property tax bill(s), which can be confusing in determining how much property tax has been paid and/or is owed.</p>	+
Operability		
Certainty The tax rules should clearly specify when the tax is to be paid, how it	<p>Payment dates and the amount due are provided by the tax collector.</p> <p>The Prop 13 formula provides certainty as to the amount of property tax owed. Owners of real property subject to Prop 13 can also project their property tax change from year to year. Generally, certainty exists for</p>	+

is to be paid, and how the amount to be paid is to be determined.	business personal property as well in that owners already keep tax records of what they purchase and sell. Uncertainty can arise regarding the proper depreciation schedule to use to determine the value of business personal property though.	
Convenience of Payment A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.	Secured property taxes are due twice a year and real property owners receive a billing statement well in advance of the payment due date. Unsecured property taxes are due in a single payment. Unlike sales tax and income tax, where the amount owed is closely associated with one's income, property taxes are not tied to income. Thus, they are still owed when the owner's income drops to zero. If the owner has no other sources of funds, he or she might be forced to sell the property or borrow against it. But, this is the nature of the property tax. Since passage of Proposition 13, few usable properties have been seized for failure to pay property taxes. As secured property taxes are paid in 6-month installments and unsecured property taxes are paid in a single payment, some taxpayers may find this to be inconvenient due to the size or manageability of these payments as opposed to monthly payments. Moreover, most counties do not permit payment by credit or debit card.	0
Economy in Collection The costs to collect a tax should be kept to a minimum for both the government and taxpayers.	Generally, property owners pay the bill sent to them by the local tax collector. There is no need for the owner to do any calculations. While appeals as to valuation may be filed, it is not an appreciable number, although the number is likely to increase in economic downturns when property values drop, especially for property owned by businesses.	+
Simplicity The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.	At a fixed rate and a base that changes by a stated formula, the property tax is generally simple with respect to real property. Businesses may face valuation issues and identification issues, but they are unlikely to be significant relative to the complexities that exist for income taxes.	+
Minimum Tax Gap A tax should be structured to minimize non-compliance."	The tax gap is likely to be quite small for real property taxes because it is difficult to hide real property and government records frequently identify the property owner. Some gap will exist for business personal property due to the volume and difficulties in businesses providing accurate records to the Assessor upon request for audit. It is likely to be small though relative to the gap for other types of taxes.	+
Appropriate Government Revenues The tax system should enable the government to determine how much tax revenue will likely be collected and when.	The amount of property tax collected is not tied to government spending needs. For example, in an economic downturn that leads to a drop in property values, less property tax will be collected because the tax rate is constitutionally fixed. Also, if the economy is strong and owners are buying and selling properties, assessed values will go up and more property tax revenues will be collected. There is no correlation between either of these situations and a change in the demand for government services. Because local jurisdictions do not control the allocation of property tax dollars, it is not always viewed as an ideal tax source. This is an odd result for a property tax because it is generally viewed as a good local tax because people believe and understand that taxes on property go to the local jurisdictions that provide services to that property. Also, the allocation of the property tax among cities, counties, schools and other	0

	<p>districts within a county varies from county to county without much rationale for the differences.</p> <p>Economic development activities are challenged under the existing property tax allocation scheme because it is difficult, if not impossible, to determine how much property taxes paid by a business come back to the local jurisdictions. If the property is in an RDA (Redevelopment Agency area), better information may be available, however.</p> <p>Unlike the sales and use tax, the property tax is deductible for individuals who itemize their deductions on their federal income tax return. For some taxpayers, this deduction is reduced due to the federal alternative minimum tax. Thus, the state is able to shift some of this tax burden to the federal government. (Because property taxes are also deductible on the California personal income tax return, itemizers are able to shift part of the cost to the state as well.)</p>	
Appropriate Purpose and Goals		
<p>Neutrality The effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.</p>	<p>The certainty of the tax base and rate for real property lessens the impact – positive or negative, on decisions to buy and sell property.</p> <p>Businesses and individuals who have owned real property long enough to have significant benefit of lower property taxes relative to new owners of similar property, will often find that property taxes do affect their decision-making regarding ownership of the property. The tax savings from continuing to own their present property rather than selling it to buy a property that may be more suitable for them now is easily affected by the reality that property taxes will be higher on the new property. One offset is that transfers within the same county by homeowners age 55 or older retain the old valuation, and some counties allow the same for inter-county transfers (R&T §69.5).</p> <p>Many states and their local jurisdictions offer property tax incentives to businesses to entice them to locate or remain in the area. California is basically unable to do the same due to constitutional constraints.</p>	0
<p>Economic Growth and Efficiency The tax system should not impede or reduce the productive capacity of the economy.</p>	<p>The Prop 13 valuation system has prevented property taxes from proportionally increasing with property values. While without Prop 13, the tax rate could have been reduced or the value could have been reduced by some percentage amount to prevent escalation, taxpayers would still likely want some type of constitutional mechanism to assure them that that would happen.</p> <p>To the extent that businesses, such as manufacturers, can find more favorable property tax systems in other states, businesses can be enticed to move or expand outside California. For example, if another state caps the value per site, rather than tax a chip manufacturing plant at a greater amount than a retail store sitting on the same- size parcel of land, that state may be more attractive to the company. Of course, many other factors are relevant in any business decision as to where to locate operations.</p>	+

APPLICATION OF THE GUIDING PRINCIPLES OF GOOD TAX POLICY: UTILITY USER TAXES (UUT) IN CALIFORNIA

Scoring

- + works well
- o needs improvement

Principle	Application and Analysis	Rating
Fairness		
Equity and Fairness Similarly situated taxpayers should be taxed similarly.	<p>Generally, residents within a city or county imposing a UUT are taxed similarly to others in the same city or county. Some cities have exemptions for low-income residents, which should help to achieve vertical equity.</p> <p>Technological advances, such as Internet telephony, have led to unfairness in that such usage would not be subject to a UUT (as it is not part of the phone charges for a resident).</p>	0
Transparency and Visibility Taxpayers should know that a tax exists and how and when it is imposed upon them and others.	<p>Many consumers likely do not know of the UUT because they don't look at their utility bills with enough scrutiny. Most utility bills have the UUT separately stated. However, it is not clear from most bills how the tax was computed and why it was assessed.</p>	0
Operability		
Certainty The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.	<p>Payers of the UUT (telecom, water, gas, and electricity and cable providers) can generally find the municipal code and tax forms needed for every city and county where they have customers. While there are over 150 taxing jurisdictions for the UUT, for each city, certainty mostly exists.</p> <p>One administrative relief provision was added to California law in 1995. AB 1575 passed in 1995 (Chapter 280) added §495.6 to the Public Utilities Code. This provision requires all cities and counties that levy a telephone user's tax to provide information to the PUC on the tax rate, how the tax is collected and the frequency of collection. The PUC is to determine how often such information is to be reported. The purpose of the reporting is to provide one source from which telephone service providers, particularly long distance providers with operations in most of the taxing jurisdictions, can obtain information on the applicable UUT. The PUC is allowed to charge a fee for providing the information provided it does not exceed the direct expenses of preparing and providing the information. The PUC is not responsible for the accuracy of the information.</p>	+

Convenience of Payment A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.	Generally not an issue.	+
Economy in Collection The costs to collect a tax should be kept to a minimum for both the government and taxpayers.	Collection costs are minimized by having the service provider collect and remit the tax rather than each consumer.	+
Simplicity The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.	Within each city or county, the tax is fairly simple. However, where a service provider has customers on several taxing jurisdictions, the multitude of bases, rates and administrative procedures adds complexity for providers. Moreover, most cities do not impose an UUT: only about 160 cities out of the more than 450 cities in California impose an UUT.	0
Minimum Tax Gap A tax should be structured to minimize non-compliance.”	There is unlikely to be much of a tax gap for the UUT because the relatively small number of utility providers are aware of the rules and follow them.	+
Appropriate Government Revenues The tax system should enable the government to determine how much tax revenue will likely be collected and when.	Except where changes in utility prices changes usage in unknown ways, local governments are likely to be able to estimate UUT collections with reasonable accuracy.	+
Appropriate Purpose and Goals		
Neutrality The effect of the tax law on a taxpayer’s decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.	For the approximately 160 cities and four counties in CA that impose a UUT, the rates range from 1% to 11%, with 5% being the average rate. Some of the services subject to UUT, such as telephone and cable services, are also subject to other taxes and fees as well. Given the small cost of the UUT to consumers (relative to other taxes, such as income and sales taxes) it is unlikely that the UUT would cause a consumer to choose to live in one city versus another. However, it might cause a manufacturer to choose one city over another or to negotiate a tax break with a particular city. While the UUT might cause a consumer to use Internet telephony rather than regular phone services, savings derived from avoiding long distance phone charges is most likely the bigger incentive to engage in Internet telephony.	0
Economic Growth and Efficiency The tax system should not impede or reduce the productive capacity of the economy.	<p>If energy costs go up, such as they did in recent years in CA, a UUT on electricity or gas might cause a hardship to a business leading to a decrease in use and a decline in collections for local governments.</p> <p>Given that higher income individuals do not use a significantly greater amount of utilities than lower income individuals, the UUT is regressive which adversely impacts lower income households (unless there is a low-income exemption).</p>	0

	The tax is an added burden for utilities to deal with because of lack of conformity among jurisdictions that impose the tax. In addition, other industries are not burdened with a similar tax compliance obligation.	
--	---	--

APPLICATION OF THE GUIDING PRINCIPLES OF GOOD TAX POLICY: CALIFORNIA BANK AND CORPORATE FRANCHISE TAX

Scoring

- + works well
- o needs improvement

Principle	Application and Analysis	Rating
Fairness		
Equity and Fairness Similarly situated taxpayers should be taxed similarly.	<p>All corporations taxable in California are subject to a flat franchise tax rate and the same minimum tax. Thus, the system is not very progressive – that is, corporations with higher incomes do not pay tax at a higher rate. As noted in the comparisons with other states though (see background on the corporate income tax), many states have a flat corporate tax rate.</p> <p>The minimum tax makes the corporate income tax regressive in that corporations with income below \$9,050 will pay a flat rate of \$800. For example, a corporation with \$7,000 of taxable income owes tax of \$800 which is an average rate of 11.4%. A taxpayer with \$1000 of taxable income has an average rate of 80%. Thus, corporations with lower taxable income pay a higher percentage of that income in tax than higher income corporations.</p> <p>The current inability of corporations to fully utilize an Net Operating Loss (NOL) penalizes corporations that have a loss in a particular year relative to other corporations who may have been able to spread deductions out over years when there was sufficient revenue to utilize the deductions. While NOLs can be carried forward at 100% beginning in 2004, the 10-year carryforward period, relative to the 20-year federal period (plus a 2-year carryback period) will result in some taxpayers not being able to fully utilize the deductions that created their NOL.</p> <p>The Alternate Minimum Tax (AMT), with its depreciation adjustment, impacts capital intensive businesses more so than labor intensive ones. Thus, manufacturers disproportionately pay AMT (and more so in years when they purchase a lot of new equipment) relative to other types of businesses. This stems from the federal AMT rules.</p> <p>From 1950 to 1985, the ratio of the aggregate of tax paid to net income reported for corporations reporting net income was very close to the corporate tax rate. In contrast, in 1995 and 2000, the corporate tax rate was higher than the percentage of tax paid to net income reported. This occurred despite an increase in the minimum tax, which should have led to an increased percentage of tax paid to net income unless very few corporations were subject to the minimum tax. However, FTB data show that in 2000, at least 54.4% of corporations paid the minimum tax.¹³ The likely conclusion is that the availability of tax credits has increased since 1985 and stock option expense increased in the late 1990s (the individuals exercising the options paid income taxes on the income which may have exceeded the value of the corporate</p>	0

¹³ Franchise Tax Board, *supra*, page 142. FTB data shows that 54.4% of corporations either had loss, no income or loss, or net income below \$5,000. The cut-off point where taxable income leads to payment of the \$800 minimum tax is \$9,029 (\$800/.0886). The FTB data shows that in 2000, 6.9% of corporation returns reported net income between \$5,000 and \$9,999 so some percentage of these returns paid the minimum tax.

	<p>deduction). Further analysis and additional data are needed to understand why the tax paid as a percentage of net income for corporations reporting net income decreased in the past decade. Such information would help in better understanding whether similar taxpayers are taxed similarly.</p> <p>Analysis should also be given to the issue of the use of abusive tax shelters to determine the extent of the problem in California.</p> <p>The appeals process should be reconsidered due to the lack of a complete set of published decisions under the current system, political nature of the process (elected appeals board (SBE)), and lack of tax expertise in parts of the appeals system even though many corporate tax matters are quite complex.</p>	
Transparency and Visibility Taxpayers should know that a tax exists and how and when it is imposed upon them and others.	Corporations are well aware of state income taxes. Issues can arise as to whether a multistate business is subject to tax in a particular state. This is particularly true of corporations that do not sell tangible personal property and are therefore not covered by the protections/guidance of P.L. 86-272 (such corporations include those selling or licensing intangibles or leasing or licensing tangible property). While court cases and state regulations provide some guidance, it is often not consistent within a state and from state to state, making it difficult for a multistate corporation to always know if it owes tax in a particular state.	0
Operability		
Certainty The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.	<p>Generally, California's income tax rules are complete. However, confusion can arise over the long list of areas where California law does not conform to federal law. In addition, confusion can arise as to whether two or more businesses are unitary and therefore required to use combined reporting.</p> <p>Delays in issuing guidance to taxpayers on law changes can reduce certainty. In addition, it is not always clear when federal guidance can be relied upon, such as when it refers to a provision that California has not adopted.</p>	0
Convenience of Payment A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.	<p>Corporations pay tax in quarterly estimated installments.</p> <p>Taxpayers who find a need to challenge a Franchise Tax Board (FTB) audit decision beyond the SBE appeal must pay the disputed liability before filing in Superior Court and may therefore find this route infeasible.</p>	+
Economy in Collection The costs to collect a tax should be kept to a minimum for both the government and taxpayers.	<p>The FTB can rely to some extent on the results of IRS audits. Conformity to federal income tax rules helps reduce costs for both the state and taxpayers. Additional conformity would further reduce costs.</p>	0

Simplicity The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.	Like the federal income tax system upon which the California system is based, the state system is complex. To the extent that California conforms to a federal rule, the California system is not any more complex than the federal system. Simplicity is partially achieved by conformity, but not fully achieved because of the complexity of the federal system. ¹⁴ In addition, the number of areas where there is no conformity requires California filers to learn additional rules and creates some level of complexity and often, additional recordkeeping. The combined reporting approach used in California also creates complexity as these concepts are not the same as the consolidated return approach used for federal income tax purposes. ¹⁵	0
Minimum Tax Gap A tax should be structured to minimize non-compliance.”	The California tax gap likely isn’t too much different than that for the federal income tax system. The IRS estimates that the amount of personal income taxes not voluntarily paid is about 17% of total federal income taxes each year (83% compliance rate). IRS enforcement efforts eventually raise the compliance rate to about 87% each tax year. [GAO, <i>Reducing The Tax Gap - Results of a GAO-Sponsored Symposium</i> , GAO/GGD-95-157, June 1995, pages 2-3.] The compliance rate for corporations is likely higher than for individuals.	0
Appropriate Government Revenues The tax system should enable the government to determine how much tax revenue will likely be collected and when.	The corporate income tax is fairly predictable, although not as predictable as the California property tax. In a booming or depressed economy, there is some unpredictability, but that is the nature of an income tax.	+
Appropriate Purpose and Goals		
Neutrality The effect of the tax law on a taxpayer’s decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.	Various provisions in the income tax system – both those coming from the federal system and those added by California (such as certain tax credits) were designed to affect a taxpayer’s decision-making. For example, the California research tax credit is designed to encourage businesses to perform R&D work in California. The adverse impact to the neutrality principle from such provisions needs to be weighed against the other principles. In addition, such provisions should be evaluated periodically to determine if they are still needed and if they are helping the state to achieve the desired goal.	0

¹⁴ There has been much written about the complexity of the federal income tax system. One good reference is a 2001 report by the Joint Committee on Taxation, *Study Of The Overall State Of The Federal Tax System And Recommendations For Simplification, Pursuant To Section 8022(3)(B) Of The Federal Tax System*, JCS-3-01, available at <http://www.house.gov/jct/pubs01.html>.

¹⁵ For examples of some of the complexities and causes, see testimony of [HMatt Stolte](#), [PriceWaterhouseCoopers LLP](#), before the California Commission on Tax Policy in the New Economy, March 20, 2002; available at commerce.ca.gov/state/ttca/ttca_navigation.jsp?path=California%2527s+Economy&childPath=Tax+Commission.

<p>Economic Growth and Efficiency The tax system should not impede or reduce the productive capacity of the economy.</p>	<p>Compared to other states, California has a fairly high corporate tax rate and a high minimum tax. Also, California is dependent on the corporate income tax for a higher percentage of its revenues than other states (7.6% of California's revenue is from the corporate income tax versus 5.7% for all states on average).</p> <p>A recent study concluded that "the corporate net income tax has statistically significant negative impacts on the rate of growth in employment." In contrast, the researchers did not find that the negative impact from increases in personal income taxes and sales taxes to be statistically significant.¹⁶</p> <p>Consideration should be given as to whether the corporate tax rate and minimum tax are too high and whether this affects a business's decision as to whether or not to locate or expand in California. This analysis should also consider the impact of California's double-weighted sales factor in the apportionment formula along with a serious study of the impact of a single sales factor apportionment approach¹⁷ as some businesses are calling for today. In addition, further analysis should be performed to determine how many corporations pay the minimum tax and the impact on their business operations.</p> <p>To help align the goals of cities/counties and the state, the advantages and disadvantages of sharing the income tax with local governments, as is done in Arizona, should be explored. Such an approach could better incentivize both levels of government to attract high wage jobs to California and provide them with the infrastructure (such as housing) that they would need.</p> <p>Consideration needs to be given to what the possible economic disadvantage is to California when it does not conform to a federal provision designed to provide an incentive to businesses, such acceleration of NOL deductions during an economic downturn.</p> <p>The efforts of the legislature and tax agencies must be coordinated or made less able to act in opposition to the meaning and intention of enacted tax provisions. Some of the regulations, rulings and decisions reached by the FTB with respect to the Manufacturers' Investment Credit (MIC) were not upheld by the State Board of Equalization (SBE) because they were found to be contrary to what the legislature enacted. Such actions of the FTB can have the effect of sending a message contrary to what the legislature intended. For example, many businesses would say that the message sent with respect to the MIC rulings is that California does not have a business friendly climate.</p> <p>Ultimately, business taxes are paid by individuals in that they are passed onto customers, employees (in the form of lower wages), investors and suppliers. There is no agreement as to how much is paid by these groups. With respect to a state corporate income tax, it should be recognized that some of these individuals who ultimately pay the corporate income tax are not residents of California. Thus, some of the state's tax burden is "exported." This would not occur if the corporate income tax were eliminated and replaced with personal income taxes.</p>	0
---	--	---

¹⁶ J. William Harden and William H. Hoyt, "Do States Choose Their Mix of Taxes to Minimize Employment Losses?" *National Tax Journal*, Volume LVI, No. 1, Part 1, March 2003, page 23.

¹⁷ For an overview of the operation of a single sales factor, see a Joint Venture Tax Policy Group issues paper at http://www.jointventure.org/initiatives/tax/current_issues.html.

APPLICATION OF THE GUIDING PRINCIPLES OF GOOD TAX POLICY: CALIFORNIA PERSONAL INCOME TAX (PIT)

Background

- The California income tax was first enacted in 1935. The state income tax was set at about 25% of the federal income tax owed. The rates ranged from 1% on the first \$5,000 of income to 15% on income over \$250,000. The definition of taxable income was similar to that at the federal level and the returns were due on April 15.¹⁸
- The high level of conformity to federal law did not last. In 1982, AB 36 removed about 300 differences between the state and federal system.¹⁹ Not all federal income tax changes are adopted by the California legislature, primarily due to revenue effects. Thus, individuals must make adjustments from their federal taxable income to compute California taxable income.
- Tax rates today range from 1% to 9.3%. The 1935 top rate of 15% was reduced to 6% in 1943. The top rate was raised to 10% in 1967 and then to 11% in 1971. The top rate was lowered to 9.3% in 1987. In 1991, temporary rates at the top of 10% and 11% were enacted.²⁰
- Tax brackets began to be indexed for the effects of inflation (to prevent “bracket creep”) in 1978.²¹
- The rate structure in 2002 for a married couple with two dependent children (see 2002 tax rate schedule for details of tax calculation):
-

Taxable income range	Marginal Rate	Tax after personal and dependency exemptions, if income is at top of this bracket	Average tax rate for prior column
\$1 - \$11,668	1.0%	\$0	0%
\$11,668 - \$27,658	2.0%	\$0	0%
\$27,658 - \$43,652	4.0%	\$414	0.9%
\$43,652 - \$60,596	6.0%	\$1,431	2.4%
\$60,596 - \$76,582	8.0%	\$3,372	4.4%
Over \$76,582	9.3%	\$5,550 (assumes taxable income of \$100,000)	5.5%

- In 2000, 13.4 million full-year resident individual income tax forms were filed. These consisted of 1.6 million Forms 540EZ, 3.4 million Forms 540A and 8.4 million Forms 540.²²

¹⁸ Doerr, David R., *California's Tax Machine*, California Taxpayers' Association, 2000, pages 37, 437 - 445.

¹⁹ *Ibid*, page 191.

²⁰ *Ibid*, pages 243, 437 – 445.

²¹ *Ibid*, page 156.

- In 1998, individuals with annual income of \$200,000 or more represented less than 3% of returns filed, but about 50% of PIT collected. Individuals with adjusted gross income under \$50,000 represented over 70% of returns filed and less than 10% of PIT collected.²³ “Taxpayers with annual income of \$500,000 or more constitute about 1 percent of returns but roughly 40 percent of revenue.”²⁴ See Franchise Tax Board (FTB) data for further breakdown (<http://www.ftb.ca.gov/other/annrpt/2000/append.html>).

A January 2003 article in the *Sacramento Bee* summarizes the picture well: In 2000, about 44,000 individuals reported income of \$1 million or more. These 44,000 people represented one-third of one percent of all taxpayers, earned 21% of the income and paid 37% of the total personal income tax. In 2001, only about 29,000 individuals reported income of \$1 million or more, which was just one-fourth of one percent of the population, about 12% of the income and 25% of the tax paid. “What that means is that the decline in income on 15,000 tax returns – out of 13.5 million taxpayers and 35 million Californians – was responsible for about 80 percent of the state’s historic revenue loss.”²⁵

- The PIT does not apply to individuals until their income exceeds twice the poverty line.²⁶ In 2001, a married family of four did not owe income tax until income reached \$38,800.²⁷
- The PIT does not include an equivalent of the federal earned income tax credit (EITC).
- PIT revenues declined 26% from 2000-01 to 2001-02.²⁸ A significant part of this is due to the decline in capital gains and stock option revenue. “[T]ax revenues [from stock options and capital gains] peaked at \$17 billion in 2000-01, but fell abruptly following the stock market decline—to under \$6 billion in 2001-02. This unprecedented 66 percent decline is the key factor behind the \$10-plus billion annual mismatch between revenues and expenditures that began in 2001-02.”²⁹
- Comparison to other states:

²² Franchise Tax Board, 2001 Annual Report, page 11; available at <http://www.ftb.ca.gov/other/annrpt/2001/2001ar.pdf>.

²³ LAO, *California’s Tax System – A Primer*, January 21, page 20.

²⁴ LAO, *Governor’s Tax Increase Proposal*, 1/29/03; available at http://www.lao.ca.gov/handouts/revtax/2003/030089_HO.pdf.

²⁵ Daniel Weintraub, “As a few rich guys go, so goes state budget,” *Sacramento Bee*, January 5, 2003.

²⁶ Based on an estimated poverty line of \$18,104.

²⁷ Center for Budget and Policy Priorities, *State Income Tax Burdens on Low-Income Families In 2001*, California fact sheet; available at <http://www.cbpp.org/2-26-02sfp-ca.pdf>.

²⁸ LAO, *The 2003-04 Budget Bill: Perspectives and Issues*; available at http://www.lao.ca.gov/analysis_2003/2003_pandi/pi_part_3_anl03.html.

²⁹ LAO, *California’s Fiscal Outlook LAO Projections, 2002-03 Through 2007-08*; available at http://www.lao.ca.gov/2002/fiscal_outlook/fiscal_outlook_2002.html.

- Only 7 states do not have a personal income tax (Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming). Two others, New Hampshire and Tennessee, tax only dividend and interest income.
- 2001 PIT collection as a percentage of total tax collections – selected states:³⁰

Arizona	27.2%
California	49.3%
Colorado	51.5%
Massachusetts	57.5%
Michigan	30.5%
New York	59.0%
Oregon	74.4%
Virginia	55.2%
All States Average	37.1%

- State income tax thresholds for a married family of four in 2001 – selected states:³¹

Arizona	\$23,600
California	\$38,800
Colorado	\$28,700
Massachusetts	\$22,700
Michigan	\$12,800
New York	\$24,900
Oregon	\$15,100
Virginia	\$17,700
Average 41 states + District of Columbia	\$19,000

California had the highest threshold among the 42 taxing jurisdictions.

- Per capita comparisons, total state revenues for 2000:³²

State	Per capita	Rank
Arizona	\$3,180	50
California	\$5,092	15
Colorado	\$3,966	35
Massachusetts	\$5,042	16
Michigan	\$4,982	18
Nevada	\$3,646	42
New York	\$5,870	6
Oregon	\$6,142	4
Virginia	\$4,154	30
All state summary	\$4,489	--

³⁰ Federation of Tax Administrators; table at <http://www.taxadmin.org/fta/rate/01taxdis.html>.

³¹ Center for Budget and Policy Priorities, *State Income Tax Burdens on Low-Income Families In 2001*, available at <http://www.cbpp.org/2-26-02sfp.htm>.

³² U.S. Census Bureau, information available at <http://www.census.gov/govs/www/state00.html>.

- Individual income tax rate range for 2002 – selected states:³³

State	Tax rate range	# brackets
Arizona	2.87 – 5.04	5
California	1.0 – 9.3	6
Colorado	4.63	1
Massachusetts	5.3	1
Michigan	4.1	1
New York	4.0 – 6.85	5
Oregon	5.0 – 9.0	3
Virginia	2.0 – 5.75	4

States with a top individual tax rate equal to or greater than California's:

Montana 11.0%
 District of Columbia 9.3%

- 15 states and the District of Columbia offer some version of an EITC based on the federal EITC.³⁴
- Contribution of PIT to California revenues:³⁵

Year	PIT as % of Total Tax Collections	PIT as % of Corporation Tax Collections	PIT as % of SUT Collections
1971	22.8%	237.6%	69.9%
1980	34.1%	259.2%	98.2%
1985	37.2%	295.0%	110.3%
1990	39.3%	340.5%	121.5%
1995	36.7%	327.3%	114.3%
2000	48.4%	596.1%	168.8%
2002	45.1%	620.0%	138.8%

- As currently structured, the personal income tax base has grown faster than taxable sales and at about the same rate as assessed valuation. “Since 1990, personal income and assessed valuation have grown at roughly the same rate while taxable sales grew more slowly. Between 1990 and 2002, personal income increased by 76.7% or 4.9% per year while assessed valuation rose by 74.6% or 4.8% per year.

³³ Federation of Tax Administrators; table at http://www.taxadmin.org/fta/rate/ind_inc.html. Also see information at <http://www.taxpolicycenter.org/taxfacts/state/rates.cfm>.

³⁴ Center for Budget and Policy Priorities, *A HAND UP: How State Earned Income Tax Credits Help Working Families Escape Poverty in 2001*, 12/27/01, page 6; available at <http://www.cbpp.org/12-27-01sfp.pdf>.

³⁵ Governor's Budget Summary 2003-2004, Revenue Estimates, page 74; available at http://www.dof.ca.gov/HTML/Budgt03-04/BudgetSum03/08_Rev_Est.pdf.

Taxable sales increased by 55.4% or 3.7% per year while the California Consumer Price Index rose by 2.7% annually.”³⁶

- PIT is deductible on the individual federal income tax return for those who itemize their deductions, but is subject to the alternative minimum tax (AMT).
- City Income Tax Information – no city within California imposes an income tax. However, several states have cities that impose an income tax. Such states include Alabama, Delaware, Michigan, Missouri, New York, Ohio, and Pennsylvania. In Arizona, cities are prohibited from assessing an income tax. Instead, the state shares 15% of its income tax collections with cities based on population (*Urban Revenue Sharing*).³⁷
- Further analysis from Legislative Analyst’s Office:³⁸
 - “Some key PIT-related policy issues facing policymakers include:
 - Marginal Rate Structure. Should California's PIT marginal tax rates be reduced, and the cost be financed through base broadening?
 - Federal Conformity. Should California more fully conform to federal PIT law in areas where it currently differs, such as capital gains tax rates, depreciation, certain credits, and net operating losses?
 - Broad-Based Simplification. Should California move towards a more simplified PIT system with fewer special provisions for particular groups/businesses?
 - Targeted Simplification. Alternatively, should California leave its basic system intact, but focus on simplifications in those PIT areas where the greatest complexities for taxpayers lie, such as the AMT?
 - Tax Expenditure Programs (TEP). Are there certain PIT-related TEPs that are ineffective and inefficient, and therefore in need of elimination or modification?
 - Reliance on the PIT. Has California become overly dependent on the PIT, given that it is a somewhat volatile revenue source and now accounts for over half of the state's General Fund total?”
- As with corporate taxes, the personal income tax is administered by the Franchise Tax Board (FTB). The mission of the FTB is “to collect the proper amount of tax revenue, and operate other programs entrusted to us, at the least cost; serve the public by continually improving the quality of our products and service; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency and fairness.” The FTB began in 1929 as the Office of the Franchise Tax Commissioner (OFTC) to administer the new bank and corporate tax act. This was

³⁶ Memo of July 8, 2003 by Stephen Levy of the Institute of Regional and Urban Studies to Budget Project Friends.

³⁷ For further information see http://www.strongcities.org/04d_total_shared.htm and <http://www.azleg.state.az.us/ars/43/00206.htm>.

³⁸ Legislative Analyst’s Office, *California’s Tax System – A Primer*, January 2001; available at http://www.lao.ca.gov/2001/tax_primer/0101_taxprimer_chapter2.html.

somewhat unusual because prior to that, administration of new taxes was assigned to the State Board of Equalization (SBE) and State Controller. The OFTC was abolished in 1950 and the FTB was created. The FTB members are: the chair of the SBE, the Director of Finance, and the State Controller. An administrative executive serves as executive officer. The FTB processes over 14 million personal income tax returns annually.³⁹

Appeals of FTB decisions are heard by the State Board of Equalization (SBE). If the taxpayer's appeal is denied and the taxpayer has paid the tax and exhausted all administrative remedies, an action against the FTB may be filed in California Superior Court. There is no procedure for the FTB to file an action when it loses an appeal before the SBE. The Superior Court decisions are not officially published. The members of the SBE are elected officials and are not required to have any particular tax experience or knowledge. Judges of the Superior Court are not required to be tax experts.⁴⁰

³⁹ See FTB, *California Franchise Tax Board At a Glance*, Pub. 1041; available at http://www.ftb.ca.gov/forms/misc/1041_021402.pdf. Also see R & T §19501 and §19084.

⁴⁰ For more information on the appeal and decision process, see the 9/23/03 letter from Professor Daniel Simmons to the California Commission on Tax Policy in the New Economy. The letter supports testimony of the author before the Commission on 9/9/03 and suggests that California should have a tax court.

APPLICATION OF THE GUIDING PRINCIPLES OF GOOD TAX POLICY: CALIFORNIA SALES & USE TAX (SUT)

Background

- *History:* The California sales tax was created by the legislature when it enacted the Retail Sales Act of 1933. It was imposed on retailers for the privilege of selling tangible personal property. The impetus behind the new tax was the need to raise revenue to cover a budget deficit. The sales tax rate was 2.5% and the base was most tangible personal property. The use tax was enacted in 1935 to complement the sales tax. It was imposed on the storage, use or other consumption in California of tangible personal property purchased from any retailer on or after July 1, 1935. The use tax rate was 3%, dropping to 2.5% after June 30, 1943.

A 1963 California Appellate Court decision provided the following explanation of the use tax: “One of the chief purposes of the use tax is to help retailers in this state, who are subject to sales tax, to compete on an equal footing with their out of state competitors who are exempt from the sales tax. Thus it is intended to reach property purchased for use and storage in this state from retailers who, being outside of the territorial boundaries of California, are not subject to its laws at all. It also seeks to reach such property where the taxable event of a sales tax, i.e., the sale, occurs outside of this state or where such property is immune from the sales tax because of the Commerce Clause. ... The use tax is complementary to the sales tax, and as such is intended to supplement the latter by imposing upon those subject to it a tax burden equivalent to the sales tax in order that tangible personal property sold or utilized in this state would be taxable once for the support of the state government. ... It is not intended to apply to property subject to the sales tax. ... This does not mean, however, that all property which is subject to the sales tax is exempt from the use tax, 'but, rather, that all property not actually covered by the sales tax is subject to the use tax.' ... 'The use tax applies to property purchased for use in this state wherever purchased, unless the gross receipts from the sale have been included in the measure of the California sales tax (Rev. & Tax.Code, sec. 6401), or unless the transaction is otherwise exempted by the statute or by the state or federal Constitution.' ... The use tax is imposed upon the purchaser rather than seller and the former is primarily liable therefor. ...

- It should be pointed out, moreover, that while the California sales tax and use tax are complementary to each other, they are not interdependent. Each is a separate tax. The sales tax is imposed upon the retailer for the privilege of selling tangible personal property (§6051), while the use tax ... is upon the purchaser who stores, uses or consumes property in this state. ... The definitions contained in the 'Sales and Use Tax Law' (§§6002 to 6019 incl.), however, apply to both taxes, except where the contract specifically limits the particular definition to one and not the other. (§6002.)” [*Bank of America National Trust and Savings Association v. State Board of Equalization*, 209 Cal App 2d 780, 26 Cal Rptr 348 (First App Dist 1963).]

- As noted earlier, there are constitutional limitations on a state imposing the sales tax on vendors outside of the territorial boundaries of the state. This position was reaffirmed by the U.S. Supreme Court in 1992 in *Quill Corporation v. North Dakota*, 504 U.S. 298 (1992). In that decision, the Court ruled that to be within the Commerce Clause,⁴¹ a vendor must have a physical presence in the state before the state can impose sales tax collection obligations upon the vendor. Litigation continues in the states as to how much physical presence is required for a vendor to have nexus⁴² (taxable presence) in the state. For example, would ten hours of employee time be sufficient or a leased computer or use of a trademark? These questions are not always resolved similarly among state courts.
- In the 1940's, in addition to the state sales tax, some cities began to assess a local sales tax. By 1954, about half of California cities were imposing a sales tax which was producing significant revenue for them. Each city administered its sales tax on its own. In response to complexity concerns raised by businesses, the legislature enacted the Bradley-Burns Uniform Local Sales Tax Act in 1955. The Act allowed counties and cities to impose a sales tax with a base similar to that of the state and administered at the state level. Regulation 1802 provides that for retailers with one place of business, the sale is deemed to occur at that place of business. Thus, cities are incentivized to get businesses to locate a sales office or large retail outlets within the city borders. In contrast, district taxes (those imposed by special districts) go to the district where the delivery was made.⁴³
- Not all tangible personal property is subject to the sales and use tax. There are many exemptions, such as for food and prescription medicine. Other states also tend to have a variety of exemptions. Over half of the states exempt food from sales tax. Most states exempt equipment purchased by manufacturers.
- The combined state and local sales tax rate in California is 7.25% (January 2003). Some areas also have district sales tax(es), with the result that the rate varies among counties from 7.25% to 8.50%. The 7.25% California sales tax rate is composed of the following elements:

Rate	Jurisdiction
5.00%	State (General Fund)

⁴¹ “The Congress shall have power ... to regulate commerce with foreign nations, and among the several States, and with the Indian tribes.” [Article I, Section 8, clause 3] Courts often refer to the “dormant Commerce Clause” because the Commerce Clause does not specifically limit state activities—it just grants power to Congress to regulate commerce. In applying the dormant Commerce Clause, the courts consider the purpose served by the Commerce Clause and “whether action taken by state or local authorities unduly threatens the values the Commerce Clause was intended to serve.” *Wardair Canada v. Florida Dept. of Revenue*, 477 U.S. 1 (1986).

⁴² Nexus may be thought of as a connection between the vendor and state such that subjecting the vendor to the state's sales tax rules is neither unfair to the vendor nor harmful to interstate commerce. These two requirements of fairness to the vendor and no impediment to interstate commerce stem from the U.S. Constitution—respectively, from the Due Process Clause and the Commerce Clause. Both of these requirements must be satisfied before a state may impose sales and use tax collection responsibilities on a vendor.

⁴³ For further information on local sales and use taxes and district taxes, see SBE publications 28, 44 and 105, available at <http://www.boe.ca.gov/sutax/staxpubsa.htm>.

0.50%	State (Local Revenue Fund)
0.50%	State (Local Public Safety Fund)
1.25%	Local (County/City) (City and county operations + County transportation funds)
7.25%	Total Statewide Base Sales/Use Tax

District taxes range from 0.125% to 0.50% per district. A county may have more than one district within it or it may have no districts. For example, the tax rate in Santa Clara County is 8.25%, comprised of the standard 7.25% and two district taxes of 0.50% each.

- The combined state and local sales tax rates in the other 45 states that impose such a tax range from 4% to 9%.
- In 2000/2001, \$35.4 billion of sales and use taxes were collected in California. The sales tax represents about 10% of a city's total revenues.
- California taxes almost no services while many states tax a variety of services (for example, Hawaii and South Dakota).
- In all states, compliance with the use tax is low, particularly when taxable items are sold to consumers by remote (non-present) sellers. Some states, such as Maine, Michigan and North Carolina, attempt to simplify collection by allowing consumers to report the use tax on their personal income tax returns. In 2003, the legislature passed SB 1009 that calls for the Franchise Tax Board to add a line to personal income tax forms for reporting and remitting use tax, with the FTB charged to submit the amount collected to the State Board of Equalization. A June 2000 report from the GAO estimated that use tax compliance by individual consumers was no higher than 5%, except on auto purchases. Because cars must be registered, the use tax can be collected easily and use tax compliance is about 100%. The GAO also found that business compliance with the use tax is probably only between 65% and 80%.⁴⁴

The GAO estimated that for 2000, state and local governments may lose between \$1.6 and \$9.1 billion due to use tax non-compliance. The range in estimates is due to varying assumptions about collection rates and quantity of remote sales. The GAO also estimates that between \$0.3 and \$3.8 billion of this loss is due to Internet sales.⁴⁵ For California, the estimates of uncollected use tax on all remote sales for 2000 was between \$298 million and \$1.4 billion, and for Internet sales, between \$23 million and \$533 million.⁴⁶

- While sales taxes are paid by customers, the vendor generally has the tax compliance and collection duties.⁴⁷ In addition, in most states, errors are the liability of the vendor, rather than the buyer. The costs of complying with the tax

⁴⁴ GAO, *Electronic Commerce Growth Presents Challenges; Revenue Losses Are Uncertain*, GAO/GGD/OCE-00-165, June 2000, page 17.

⁴⁵ *Supra*, page 19.

⁴⁶ *Supra*, page 59.

⁴⁷ Some large businesses may file a "direct pay" permit with a state and self-assess any sales and use tax owed on its purchases.

rules of multiple state and local taxing jurisdictions can be quite high in terms of labor costs, training, computer systems, need for continual updates (due to changes in laws and regulations), audits, and error. A recent study by the State of Washington on sales tax compliance costs reached the following conclusions:⁴⁸

Costs as a percent of total state and local sales tax collections:

Small business	6.47%	(gross sales between \$150,000 and \$400,000)
Medium business	3.35%	(gross sales between \$400,000 and \$1,500,000)
Large business	0.97%	(gross sales over \$1,500,000)
Total cost weighted by number	4.23%	
Total cost weighted by dollars	1.42%	

A 1999 study by Ernst & Young LLP concluded that the costs of administering state and local sales taxes were primarily borne by vendors. The report notes that a large multistate vendor in 15 states would have compliance costs equal to approximately 8.3% of the sales and use taxes paid. Added compliance costs for multistate vendors include variations across states as to what is taxable and dealing with numerous tax base and tax rate changes enacted by the states each year. The report also noted that e-commerce vendors face additional costs over traditional vendors. For example, there would be added costs of collecting information about the buyer's location, particularly for the sale of digitized products.⁴⁹

The costs of compliance can also be complicated and costly due to the frequent changes that are made to tax rules and forms. While many companies rely on software systems for compliance, such systems can be expensive to both obtain and maintain. Also, many large companies find that they need to create their own software systems rather than purchase “canned” programs. In addition, the software is not a replacement for personnel who are needed in sufficient number to meet the filing obligations of the vendor. One large U.S. company with over \$40 billion of revenues has stated that it has twice as many employees involved with sales and use tax compliance than with federal and state income tax compliance, planning, and audit activities.⁵⁰

- The Streamlined Sales Tax Project (SSTP) stems from the simplification suggestions made in the minority report of the federal Advisory Commission on E-Commerce (formed by the Internet Tax Freedom Act) and suggestions of the

⁴⁸ Washington State Department of Revenue, *Retailers' Cost of Collecting and Remitting Sales Tax*, December 1998; <http://www.wa.gov/dor/reports/retail/retailsum.htm>. The report also notes that the costs of collection can be offset somewhat by the float that retailers enjoy due to the lag between collection and remittance of the tax, and the ability to deduct these costs on their income tax returns.

⁴⁹ Robert J. Cline and Thomas S. Neubig, *Masters of Complexity and Bearers of Great Burden: The Sales Tax System and Compliance Costs for Multistate Vendors*, September 1999.

⁵⁰ Testimony of Dan Kostenbauder, General Tax Counsel, Hewlett Packard Company, before the Advisory Commission on Electronic Commerce, December 15, 1999, available at www.ecommercecommission.org/sanFran/tr1215.htm.

National Governors Association (NGA) in 1999. A group of representatives from over 35 states met throughout 2000 to create a Model Act and Agreement for a uniform and simplified sales and use tax act. California was not involved in this effort. The language was approved by the participating states in December 2000. Additional work was done and a final agreement was reached in November 2002. The mission of the SSTP: “The Streamlined Sales Tax Project will develop measures to design, test and implement a sales and use tax system that radically simplifies sales and use taxes.”⁵¹

SB 1949, introduced in February 2000, would have directed the Governor to enter into discussions with other states “regarding the development of a multistate, voluntary, streamlined system for sales and use tax collection and administration.” SB 1949 was passed in both the California Assembly and Senate, but was vetoed by Governor Davis in September 2000 because he deemed it unnecessary. He noted that California already participates in such forums as the Multistate Tax Commission and National Governor’s Association that work on tax simplification activities.

SB 157 (Chapter 702) enacted in October 2003, creates the “Streamlined Sales Tax Project,” a governance board to represent California in meetings related to the Streamlined Sales and Use Tax Agreement (SSUTA). The Board will consist of 2 members of the Senate, 2 from the Assembly, one member from the SBE, one from the FTB and one person from the Governor’s Department of Finance.

Diverse views exist among vendors and state and local governments as to whether the SSTP will be a better system. Some vendors see benefits of having a more uniform sales and use tax system across jurisdictions and more fair competition should the project be successful in enabling states to collect use tax from remote vendors. On the other hand, some vendors are concerned that the number of jurisdictions in which they have filing obligations will increase (such as when the taxing point of a pizza delivery business is changed from vendor’s location (origin) to point of delivery). Some cities that currently collect significant sales tax from a business base that sells within the city’s borders to other cities in the state are concerned that they will lose sales tax revenue when the sales tax shifts to point of delivery (other cities). The House Judiciary’s Subcommittee on Commercial and Administrative Law held a hearing on the SSTP on October 1, 2003, where some of these pro and con arguments were raised. See testimony for this hearing at <http://www.house.gov/judiciary/commercial.htm>, as well as various sites of business and city/county organizations.

- From 1980 – 1990 and 1990 – 2002, taxable sales grew at a slower rate than personal income or assessed valuation. “Between 1990 and 2002, personal income increased by 76.7% or 4.9% per year while assessed valuation rose by 74.6% or 4.8% per year. Taxable sales increased by 55.4% or 3.7% per year

⁵¹ See <http://www.geocities.com/streamlined2000/>.

while the California Consumer Price Index rose by 2.7% annually.”

“The volatility of taxable sales is explained by the close link between business and consumer spending and the business cycle. In all recent recessions, spending has fallen by more than income. It is reasonable to expect that taxable sales will continue to be the most volatile of the three major tax bases.”⁵²

- The sales and use tax is administered by the State Board of Equalization (SBE). The SBE consists of five elected members. The state is split into four districts with each one electing a board member. The fifth board member is the State Controller, serving in an ex officio role. The SBE serves administrative functions as well as some quasi-judicial ones. It is an appellate body for appeals on certain business tax assessments, Franchise Tax Board actions, and public utility assessments. The three general tax areas the SBE oversees are (1) sales and use taxes, (2) property taxes (but it does not assess local properties), and (3) special taxes, such as those on cigarettes and fuel.

The Final Report of the California Constitution Revision Commission of 1996 included a recommendation to abolish the SBE. This recommendation also included merging the functions of the SBE, Franchise Tax Board, and other major revenue agencies into a combined Department of Revenue. The Commission also recommended creating a tax appeals board that would be appointed by the Governor and confirmed by the Senate. In addition to the problems of an elected tax board, the Report notes the fragmentation of tax administration under the present system and the lack of accountability. In addition, economies of scale would be realized by consolidation of the administrative and audit functions of the current tax agencies. The Report notes that since 1929, there have been several studies that have called for the SBE to be eliminated.⁵³

⁵² Memo of July 8, 2003 by Stephen Levy of the Institute of Regional and Urban Studies to Budget Project Friends.

⁵³ California Constitution Revision Commission, *Final Report and Recommendations to the Governor and the Legislature*, 1996, pages 2 and 20 – 22.

APPLICATION OF THE GUIDING PRINCIPLES OF GOOD TAX POLICY: CALIFORNIA PROPERTY TAX

Background⁵⁴

Nature of the tax: The property tax is best described as an *ad valorem* tax based on a percentage of value of property; it is not tied to the property owner's income or consumption. That is, the amount of property tax owed is not dependent on income, but on the value (as measured under the state's property tax valuation laws) of the property. Real property is taxed by the jurisdiction in which it is located (rather than where the owner is located). Personal property subject to the California property tax is taxed based on where it has obtained a permanent situs (rather than on where the owner is located).

History: The property tax has existed in California since 1849.⁵⁵ The property tax is a local tax. Since 1933, the only property tax that the state assesses, collects and keeps is one on privately-owned public utilities and railroad cars (\$6.5 million of assessed value and \$171 in local property tax revenues in 2002-2003).⁵⁶

What is subject to tax: The California property tax is generally assessed on all real property and tangible personal property unless an exemption applies. Significant exemptions for tangible personal property include personal effects and business inventories. Significant exemptions for real property include the homeowner's exemption which reduces the assessed valuation of an owner-occupied home by \$7,000; property used exclusively for non-profit organizations, public schools, community colleges, state colleges and state universities; and exemptions for church property and growing crops.

Proposition 13: For real property, the valuation for property tax purposes is based on the 1975-1976 valuation amount ("Prop 13" system). If the property has transferred ownership, is purchased new, or was constructed (including additional new construction) after 1976, it is reassessed at market value (frequently, the purchase price). Valuations may only increase annually at no greater than the inflation rate or 2%, whichever is lower. Pursuant to Proposition 8, if the market value decreases below the original assessed value (the factored base year value), the assessed value is temporarily decreased until the market value exceeds original assessed value plus the inflation rate. This valuation system, commonly referred to as an acquisition-based property tax system as opposed to market-based, has led to "dramatic disparities" [U.S. Supreme Court in *Nordlinger*] of the property taxes assessed on properties that are similar but were purchased at different times. The valuation system was upheld in 1992 under the Equal Protection clause of the 14th Amendment by the U.S. Supreme Court in a case involving residential property (*Nordlinger v. Hahn*, 505 U.S. 1 (1992)).

⁵⁴ Additional Reference: SBE Publication 29 - California Property Tax, An Overview (9/02) available at <http://www.boe.ca.gov/proptaxes/pdf/pub29.pdf>.

⁵⁵ Legislative Analyst's Office, *California's Tax System – A Primer*, Chapter 6, January 2001, available at http://www.lao.ca.gov/2001/tax%5Fprimer/0101_taxprimer_chapter6.html.

⁵⁶ State Board of Equalization's 2001-2002 Annual Report, Property Tax section – page 14, available at <http://www.boe.ca.gov/annual/>.

Prop 13 generally limits the tax rate to 1%.

The Prop 13 valuation method does not apply to locally assessed business personal property or utilities, railroads and other properties assessed by the State Board of Equalization (that is, not assessed by counties).

Property Tax Relief Measures: In addition to the homeowner's exemption, which a majority of states provide, California also provides limited relief to low-income homeowners and renters age 62 and over. Property tax assistance of a few hundred dollars is administered by the Franchise Tax Board for low-income homeowners or renters age 62 and over, blind or disabled. Homeowners file Form 9000 to claim relief and renters file Form 9000R. Homeowners who are age 62 or older, blind or disabled may also obtain postponement of all or a portion of their property taxes. Basically, the state pays the taxes and a lien is placed on the property; thus, it is a postponement of payment. These types of relief and postponement provisions are provided by many states.

Exclusion from normal reassessment is also available for seniors and certain intrafamily transfers. Homeowners who are at least age 55 or disabled may transfer the taxable value of their home to a replacement home of equal or lesser value within the same county and maintain the equivalent prior assessed value. Certain counties allow such relief for intercounty transfers. In addition, the purchase or transfer of a principal residence and the first \$1 million of other real property between parents and children will not be reassessed if a claim is filed within specified time limits. This relief also applies to transfers between grandparents and grandchildren if both qualifying parents are deceased.

Allocation of property tax dollars: In 2001-2002, over \$27.1 billion of property tax dollars were raised. On average, this amount was allocated 19% to counties, 11% to cities, 52% to schools and 18% to special districts.⁵⁷ Allocation of property taxes to cities, counties, schools, and other districts is not consistent among counties, however. See Table 14 and Table 15 from the State Board of Equalization's 2001-2002 Annual Report. [<http://www.boe.ca.gov/annual/statindex0102.htm#pt>]

Local or State Tax? Many people likely believe that the property tax is a local tax. The amount owed is determined by a county collector (for most property) and payment is made to a local tax collector, rather than to the state. However, after Proposition 13, most *control* over property tax allocations rests with the state. The 1996 report of the California Constitution Revision Commission noted that the property tax, "once a local tax for local purposes, is now treated as a tax for state purposes."⁵⁸ A 2000 report by the Legislative Analyst's Office noted that one of the problems with the allocation of the property tax is the lack of local control. The report explains that the distribution of property tax revenues among local jurisdictions is mostly the same as it was in the 1970s. For example, a water district may receive the same property tax allocation today as it did 25 years ago even though its services today may be funded with user charges. Also, local residents who seek a higher level of service from their city or county are powerless

⁵⁷ SBE, *California Property Tax – An Overview*, Publication 29, 9/02, page 1.

⁵⁸ California Constitution Revision Commission, *Final Report and Recommendations to the Governor and the Legislature*, 1996, p. 64.

to reallocate the property tax among the local jurisdictions to cover the service. The only solution is to approve an assessment or special tax. Finally, local governments are vulnerable to the state shifting property tax dollars to the state, as was done with the Educational Revenue Augmentation Fund (ERAF).⁵⁹

Tax Stats:

Valuations ⁶⁰ (net exemptions)	2001-2002	2002-2003
State assessed property values	\$63.3 billion	\$65.17 billion
County-assessed property values	\$2.5 trillion	\$2.69 trillion

The assessed value of property grew by 10.5% per year between 1980 and 1990, but only 4.8% since 1990. In comparison, between 1980 and 1990, there was 7.5% annual growth in population and inflation, and 4.2% since 1990.⁶¹ [Both pop and inflation grew by exactly 7.5% each or combined?]

*Issues per the Legislative Analyst's Office:*⁶²

“THE PROPERTY TAX HAS NUMEROUS ISSUES ASSOCIATED WITH IT.

- *Basic Fairness of the Tax.* Under current assessment methods, owners of identical properties can pay vastly different taxes solely based on when the property was purchased.
- *Property Tax Allocations.* The most appropriate way of allocating the property tax among local governments continues to be a topic of discussion and debate.
- *Personal Property Assessment.* Issues have been raised regarding the appropriate methodologies used for assessing the value of personal property, which largely affects businesses.”

Further Information on California Property Taxes: See SBE Publication 29 - California Property Tax, An Overview (9/02) available at <http://www.boe.ca.gov/proptaxes/pdf/pub29.pdf>, and SBE Annual Reports available at <http://www.boe.ca.gov/annual/annualrpts.htm>.

Comparison Among States:

A. Local Property Taxes as a Percent of Local Taxes, FY 1999⁶³

Local property taxes are a significant revenue source for U.S. local governments as indicated below. California is below the national average in its dependence on property

⁵⁹ LAO, *Reconsidering AB 8: Exploring Alternative Ways to Allocate Property Taxes*, February 2000, pp. 4 – 5.

⁶⁰ State Board of Equalization's 2001-2002 Annual Report, Table 4, available at <http://www.boe.ca.gov/annual/>.

⁶¹ Memo of July 8, 2003 by Stephen Levy of the Institute of Regional and Urban Studies to Budget Project Friends.

⁶² *Primer, supra.*

⁶³ National Conference of State Legislatures, *A Guide to Property Taxes: An Overview*, May 2002, p. 12.

taxes at the local level. This is likely due to the 1% rate cap and assessed value cap, as well as the importance of the sales tax to local governments.

State	Percent	Rank
Arizona	70.6	32
California	66.2	34
Colorado	61.5	40
Massachusetts	96.9	6
Michigan	89.8	14
Nevada	63.3	38
New York	57.0	44
Oregon	80.1	20
Virginia	71.7	31
All states	72.3	--

B. Property Taxes as a Percent of Total State and Local Revenue FY 1999^{64]}

State	Percent	Rank
Arizona	13.94	20
California	10.49	36
Colorado	13.43	21
Massachusetts	17.62	8
Michigan	13.33	22
Nevada	10.76	35
New York	14.37	17
Oregon	11.10	33
Virginia	14.42	16
All states	13.38	--

⁶⁴ National Conference of State Legislatures, *A Guide to Property Taxes: An Overview*, May 2002, p. 30.

C. Property Taxes Per Capita and as a Percentage of Personal Income, FY 1999⁶⁵

State	Collections in thousands	Per Capita		Per \$100 Income	
		Amount	Rank	Amount	Rank
Arizona	\$3,584,155	\$750.1	32	\$3.2	24
California	25,424,960	767.1	31	2.8	33
Colorado	3,413,607	841.6	23	2.9	31
Massachusetts	7,300,559	1,182.3	8	3.6	16
Michigan	8,810,590	893.2	19	3.3	22
Nevada	1,261,135	697.1	33	2.4	39
New York	24,758,694	1,360.6	4	4.2	9
Oregon	2,558,189	771.5	30	3.0	28
Virginia	5,757,546	837.7	24	3.0	29
All states	\$239.427,272	879.7	--	3.3	--

D. Other Measures of Assessed Value

Some states have different valuation and assessment ratios for different classes of property. Some states, such as Oregon, have a constitutionally set maximum assessed value for each property. Some may allow for property tax reductions for purposes of economic development.

⁶⁵ National Conference of State Legislatures, *A Guide to Property Taxes: An Overview*, May 2002, p. 15.

**TABLE 14 – 2000-01 GENERAL PROPERTY TAX LEVIES AS COMPILED FOR
COMPUTATION
OF THE AVERAGE TAX RATE** (Levies and assessed values in thousands of dollars)

County	Net taxable ^a assessed value	City	Property tax allocations and levies ^b			Total ^d	Average tax rate	
			County ^c	School ^c	Other ^d districts		2000-01	1999-00
1	2	3	4	5	6	7	8	9
Alameda	\$110,060,850	\$251,707	\$184,030	\$560,604	\$246,682	\$1,243,023	1.129%	1.134%
Alpine	285,745	–	1,807	753	297	2,857	1.000	1.000
Amador	2,419,457	984	7,971	14,809	431	24,195	1.000	1.000
Butte	10,401,153	5,962	13,702	70,169	18,344	108,177	1.040	1.040
Calaveras	3,262,168	239	6,407	22,676	4,763	34,085	1.045	1.044
Colusa	1,733,974	879	4,899	10,191	1,353	17,322	0.999	0.999
Contra Costa	83,102,679	76,832	111,499	437,809	251,936	878,076	1.057	1.063
Del Norte	1,047,189	95	1,918	6,841	1,628	10,482	1.001	1.001
El Dorado	12,424,735	3,670	29,582	63,539	31,612	128,403	1.033	1.039
Fresno	34,106,100	51,697	44,772	247,719	45,286	389,474	1.142	1.131
Glenn	1,572,002	1,011	3,237	11,027	701	15,976	1.016	1.013
Humboldt	6,348,653	1,857	12,772	40,624	8,995	64,248	1.012	1.013
Imperial	6,293,900	5,139	11,447	43,487	11,135	71,208	1.131	1.099
Inyo	2,435,523	298	7,434	15,566	1,626	24,924	1.023	1.001
Kern	42,209,013	23,294	121,677	263,741	50,075	458,787	1.087	1.095
Kings	4,442,430	2,994	11,377	26,718	6,139	47,228	1.063	1.059
Lake	3,495,752	908	8,508	20,367	5,750	35,533	1.016	1.014
Lassen	1,447,186	599	2,860	10,716	754	14,929	1.032	1.027
Los Angeles	581,226,946	997,654	1,542,409	2,532,770	1,163,358	6,236,191	1.073	1.068
Madera	6,211,635	1,771	9,673	46,775	5,808	64,027	1.031	1.025
Marin	30,958,871	36,059	58,047	180,752	45,389	320,247	1.034	1.023
Mariposa	1,189,731	–	3,070	8,240	626	11,936	1.003	1.001
Mendocino	5,716,567	948	16,516	36,448	6,466	60,378	1.056	1.053
Merced	9,590,787	6,163	22,211	61,462	9,047	98,883	1.031	1.018
Modoc	711,467	230	1,965	4,527	393	7,115	1.000	1.000
Mono	2,243,923	727	6,742	9,103	6,346	22,918	1.021	1.020
Monterey	27,617,259	18,863	46,006	175,584	41,727	282,180	1.022	1.020
Napa	12,582,819	12,215	28,640	84,332	4,345	129,532	1.029	1.033
Nevada	8,011,172	5,360	12,247	47,946	15,910	81,463	1.017	1.011
Orange	225,391,305	248,009	243,253	1,432,372	409,114	2,332,748	1.035	1.035
Placer	24,231,322	16,333	49,331	160,707	29,297	255,668	1.055	1.045
Plumas	2,217,021	153	4,812	14,653	2,554	22,172	1.000	1.000
Riverside	88,025,025	56,718	115,654	453,339	314,766	940,477	1.068	1.079
Sacramento	63,669,662	62,728	126,054	338,453	138,855	666,090	1.046	1.037
San Benito	3,805,950	994	5,884	23,759	9,396	40,033	1.052	1.082
San Bernardino	81,981,706	64,659	108,342	411,499	314,696	899,196	1.097	1.095
San Diego	192,488,886	258,673	287,804	1,285,516	214,652	2,046,645	1.063	1.062
San Francisco ..	77,649,539	–	566,050	249,270	64,743	880,063	1.133	1.132
San Joaquin	28,940,756	32,282	64,204	162,228	31,131	289,845	1.002	1.002
San Luis Obispo	21,758,815	15,572	55,295	157,562	12,361	240,790	1.107	1.103
San Mateo	80,120,297	86,719	122,169	509,420	111,374	829,682	1.036	1.035
Santa Barbara ..	32,566,457	15,905	65,386	200,546	52,902	334,739	1.028	1.035
Santa Clara	173,399,110	157,236	271,286	1,155,838	327,582	1,911,942	1.103	1.091
Santa Cruz	19,432,444	11,527	30,177	122,242	41,959	205,905	1.060	1.038
Shasta	8,873,806	6,187	12,879	64,891	12,055	96,012	1.082	1.081
Sierra	406,786	26	2,228	1,396	579	4,229	1.040	1.034
Siskiyou	2,570,930	1,618	5,940	17,427	1,044	26,029	1.012	1.014
Solano	22,708,182	32,438	40,200	107,606	64,496	244,740	1.078	1.086
Sonoma	35,732,663	23,356	81,470	238,088	45,850	388,764	1.088	1.089
Stanislaus	20,427,521	13,129	24,171	164,533	15,493	217,326	1.064	1.073
Sutter	4,458,105	3,092	8,299	29,135	4,964	45,490	1.020	1.000
Tehama	2,698,361	1,183	6,858	18,144	926	27,111	1.005	1.006
Trinity	713,730	–	2,171	4,619	368	7,158	1.003	1.003
Tulare	15,380,658	8,846	32,838	98,613	18,790	159,087	1.034	1.033
Tuolumne	3,629,657	261	10,970	23,562	2,027	36,820	1.014	1.015
Ventura	56,223,638	47,312	97,437	320,955	136,536	602,240	1.071	1.069
Yolo	10,486,358	17,674	10,624	62,578	17,401	108,277	1.033	1.006
Yuba	2,367,330	897	5,182	15,792	2,195	24,066	1.017	1.016
TOTAL	\$2,315,505,706	\$2,691,682	\$4,790,393	\$12,900,038	\$4,385,028	\$24,767,141	1.070%	1.067%

- a. These are the assessed values on which general property taxes were actually levied in 2000-01. Excluded are exemptions totaling \$99,271,272,000 as follows: homeowners', \$36,396,322,000; all other, \$62,874,950,000.
- b. The county levies at a rate of 1 percent of assessed value have been allocated among the jurisdictions receiving a portion of those levies. Excluded are the state reimbursements to local governments of \$398,362,000 for the homeowners' exemption described in footnote a.
- c. County levies for school purposes such as junior college tuition and countywide school levies are included with school levies.
- d. Includes debt levies on land and/or improvements only. Also includes the portion of the 1 percent levy allocated to jurisdictions previously taxing less than total property.

TABLE 15 – 2000-01 GENERAL PROPERTY TAX DOLLAR^a, BY COUNTY

County 1	City 2	County ^b 3	Property tax dollars		Total 6
			School ^b 4	Other districts 5	
Alameda	\$.20	\$.15	\$.45	\$.20	\$1.00
Alpine	–	.63	.26	.11	1.00
Amador .....	.04	.33	.61	.02	1.00
Butte .....	.05	.13	.65	.17	1.00
Calaveras .....	.01	.19	.66	.14	1.00
Colusa .....	.05	.28	.59	.08	1.00
Contra Costa .....	.09	.13	.50	.28	1.00
Del Norte .....	.01	.18	.65	.16	1.00
El Dorado .....	.03	.23	.49	.25	1.00
Fresno .....	.13	.11	.64	.12	1.00
Glenn .....	.06	.20	.69	.05	1.00
Humboldt .....	.03	.20	.63	.14	1.00
Imperial .....	.07	.16	.61	.16	1.00
Inyo .....	.01	.30	.62	.07	1.00
Kern .....	.05	.27	.57	.11	1.00
Kings .....	.06	.24	.57	.13	1.00
Lake .....	.03	.24	.57	.16	1.00
Lassen .....	.04	.19	.72	.05	1.00
Los Angeles .....	.16	.25	.40	.19	1.00
Madera .....	.03	.15	.73	.09	1.00
Marin .....	.11	.18	.57	.14	1.00
Mariposa	–	.26	.69	.05	1.00
Mendocino .....	.02	.27	.60	.11	1.00
Merced .....	.06	.23	.62	.09	1.00
Modoc .....	.03	.28	.64	.05	1.00
Mono .....	.03	.29	.40	.28	1.00
Monterey .....	.07	.16	.62	.15	1.00
Napa .....	.10	.22	.65	.03	1.00
Nevada .....	.07	.15	.59	.19	1.00
Orange .....	.11	.10	.61	.18	1.00
Placer .....	.06	.19	.63	.12	1.00
Plumas .....	.01	.22	.66	.11	1.00
Riverside .....	.06	.12	.48	.34	1.00
Sacramento .....	.09	.19	.51	.21	1.00
San Benito .....	.03	.15	.59	.23	1.00
San Bernardino .....	.07	.12	.46	.35	1.00
San Diego .....	.13	.14	.63	.10	1.00
San Francisco	–	.64	.28	.08	1.00
San Joaquin .....	.11	.22	.56	.11	1.00
San Luis Obispo .....	.07	.23	.65	.05	1.00
San Mateo .....	.11	.15	.61	.13	1.00
Santa Barbara .....	.05	.19	.60	.16	1.00
Santa Clara .....	.08	.14	.61	.17	1.00
Santa Cruz .....	.06	.15	.59	.20	1.00
Shasta .....	.06	.13	.68	.13	1.00
Sierra .....	.01	.52	.33	.14	1.00
Siskiyou .....	.06	.23	.67	.04	1.00
Solano .....	.13	.17	.44	.26	1.00
Sonoma .....	.06	.21	.61	.12	1.00
Stanislaus .....	.06	.11	.76	.07	1.00
Sutter .....	.07	.18	.64	.11	1.00
Tehama .....	.04	.25	.67	.04	1.00
Trinity	–	.30	.65	.05	1.00
Tulare .....	.05	.21	.62	.12	1.00
Tuolumne .....	.01	.30	.64	.05	1.00
Ventura .....	.08	.16	.53	.23	1.00
Yolo .....	.16	.10	.58	.16	1.00
Yuba .....	.04	.21	.66	.09	1.00
TOTAL	\$.11	\$.19	\$.52	\$.18	\$1.00

- a. Includes ad valorem levies for debt service on land and/or improvements only, but excludes special assessments levied on other than an ad valorem basis (e.g. per parcel).
- b. County levies for school purposes such as junior college tuition and countywide school levies are included with school levies.

APPLICATION OF THE GUIDING PRINCIPLES OF GOOD TAX POLICY: CALIFORNIA TELECOMMUNICATIONS TAXES AND FEES

Background

- There are a variety of assessments on telecommunications services. These assessments include both taxes and fees and are imposed at both the state and local levels. Thus, there is no single “telecom tax” in California. In addition to specific taxes and fees pertinent to companies providing various telecommunications services, special rules and issues exist under the other key taxes. For example, significant assets for some telecom companies are FCC licenses. Yet, as an intangible, the licenses are not included in apportionment factors for income tax purposes. Also, property of regulated telephone companies is assessed by the state rather than by the county, and the Prop 13 valuation system does not apply. Because telecommunications services are not tangible personal property, they are not subject to sales and use taxes.
- Cities and Counties charge franchise fees for the right of companies to lay cable lines, with the fee representing fair rental for using the property. Unlike most states, local governments in California may impose franchise fees only upon cable and energy companies and not upon telephone companies. The difference in treatment in California comes from a law passed in 1850 to promote the establishment of telegraph, and later telephone service in the State. In 1959 the California Supreme Court ruled in *The Pacific Telephone and Telegraph Company v. City and County of San Francisco*, that “construction and maintenance of telephone lines in the streets and other public places within the city is today a matter of state concern and not a municipal affair.”⁶⁶ The court noted that since 1850, state statute authorized the construction and maintenance of telegraph lines along roads and other public places in the state. In 1905, the statute was expanded to also cover telephone corporations and telephone lines.⁶⁷ Federal law prohibits jurisdictions from imposing a franchise fee on cable companies greater than 5% of the operator’s 12-month gross receipts. Franchise fees must represent “fair and reasonable compensation” for the jurisdiction’s management and maintenance of public rights of way (rent), rather than serve as a source of general revenues. In some cases, a portion of these fees is also used to help pay for the cost of educational, government and public access (PEG) programming that is broadcast on the cable system.
- The state imposes a variety of taxes and surcharges. “The majority of statewide taxes and surcharges provide funding for telecommunications public programs

⁶⁶ *The Pacific Telephone and Telegraph Company v. City and County of San Francisco*, 51 Cal.2d 766, 768, 336 P.2d 514 (CA Sup Ct. 1959). Also see *The Pacific Telephone and Telegraph Company v. City and County of San Francisco*, 197 Cal.App.2d 133 (1st App 1961).

⁶⁷ The current statute is California Public Utilities Code §7901, formerly Civil Code §536. CPUC §7901 provides: “Telegraph or telephone corporations may construct lines of telegraph or telephone lines along and upon any public road or highway, along or across any of the waters or lands within this State, and may erect poles, posts, piers, or abutments for supporting the insulators, wires, and other necessary fixtures of their lines, in such manner and at such points as not to incommode the public use of the road or highway or interrupt the navigation of the waters.”

established by the California Public Utilities Commission (CPUC) to achieve the state's universal service goals of affordability and availability of basic telephone service to all Californians."

"The CPUC has created five public programs to achieve its universal service goals:

- The Deaf and Disabled Telecommunications Program (DDTP) and Telecommunications Device for the Deaf Placement Program (TDPP), which provide relay service and communications devices to deaf and disabled consumers;
- The Universal Lifeline Telephone Service (ULTS) program, which provides discounted basic telephone services to low-income consumers;
- The California High Cost Fund-A (CHCF-A), which subsidizes the 17 incumbent small local exchange companies (LECs) to reduce any disparity in the rates charged by these companies;
- The California High Cost Fund-B (CHCF-B), which subsidizes the few largest incumbent LECs in their high-cost areas, to reduce any disparity in their rates; and
- The California Teleconnect Fund (CTF), which provides discounted services to schools, libraries, municipal and county government-owned hospitals and health clinics, and community-based organizations."

"Other state-imposed fees include the California 911 surcharge, the state regulatory fee, and fees to fund payphone programs."⁶⁸

- "In 2001 California was tied with Colorado, Illinois, and Louisiana for the second highest number of state taxes on telecommunications sales: seven.ⁱ Only New Mexico, New York, and Texas had more, each with eight. The national average is four. Arizona, Florida, and Washington each have five, Oregon has four, and Nevada has three."⁶⁹
- In recent years, some states, such as Florida and Illinois have consolidated their multiple telecom taxes into a single tax.

Utility User Taxes

Over 150 California cities and counties impose a UUT on use within their borders of telephone service, water, gas, electricity and/or cable service. The tax rate is applied to the charges for the particular utility service. The base varies from city to city, as does the rate (from 0% to 11%). For example, some cities tax all telephone services while others only tax intrastate calls. Also, some cities tax cable service while others do not.

⁶⁸ *The Taxation of Telecommunications in California in the Information Age*, James E. Prieger, Terri A. Sexton, and Annette Nellen, April 2003; available at <http://www.ucop.edu/cprc/publist.html#ECONOMIC>.

⁶⁹ *Supra*.

For more information, see *The Taxation of Telecommunications in California in the Information Age*, James E. Prieger, Terri A. Sexton, and Annette Nellen, [*Report*](#), April 2003, 172 pp.; *Brief*, Vol. 15, No. 4, April 2003, 4 pp.; available at <http://www.ucop.edu/cprc/publist.html#ECONOMIC>.

APPLICATION OF THE GUIDING PRINCIPLES OF GOOD TAX POLICY: CALIFORNIA BANK AND CORPORATE FRANCHISE TAX (BCT)

Background

- The bank and corporation tax began in 1911 as a 1% tax on the book value of their franchises. This tax system was changed by a 1928 initiative that changed the California Constitution to impose a tax on the net income of banks and corporations. There was a minimum franchise tax of \$25. The determination of net income mainly followed federal income tax rules. Net income of multistate corporations allocable to California was determined based on property, sales and payroll factors. Banks were liable for an additional “add-on” rate paid in lieu of personal property taxes.⁷⁰

Corporate income tax rates have ranged from 2% in 1933 to 7.6% in 1972 to 9.0% in 1974 – 1979, 9.6% in 1980-1986. Today, the rate is 8.84%. The bank franchise rate and add-on rate has ranged from 6% in 1933, 11.6% in 1972, 12.978% in 1975. Today, the rate for bank and other financial corporations is 10.84%. The alternative minimum tax rate (AMT) for banks and corporations is 8.65% and 6.65%, respectively. The minimum franchise tax today for C and S corporations, banks and other financial corporations is \$800.⁷¹ S corporations are subject to a 1.5% tax rate (when greater than the \$800 minimum tax).

- The franchise tax is imposed on corporations “doing business” in California. It is measured using taxable income of the current tax year for the privilege of doing business in that year. “Doing business means actively engaging in any transaction for the purpose of financial gain or profit. ... It is not necessary that the corporation conducts business or engages in transactions within the state on a regular basis. Even an isolated transaction during the year may be enough to cause the corporation to be ‘doing business.’” [2002 Form 100 booklet, page 5]
- Corporations subject to the minimum franchise tax are those that are (1) incorporated or organized in California, (2) qualified or registered to do business in California, or (3) doing business in California. The minimum franchise tax is owed even by inactive and loss corporations, as well as those not doing business in California. The minimum franchise tax does not apply in a corporation’s first tax year.
- The California corporate income tax is “imposed on all corporations that derive income from sources within California but are not doing business in California.” [2002 Form 100 booklet, page 5] This is a limited category of businesses. An example would be a non-California corporation that is a limited partner in a limited partnership doing business in California, but the corporation itself is not doing business in California.

⁷⁰ Doerr, David R., *California’s Tax Machine*, California Taxpayers’ Association, 2000, pages 374 - 379.

⁷¹ Franchise Tax Board, Annual Report 2001, pages 67 - 68; available at <http://www.ftb.ca.gov/other/annrpt/2001/2001ar.pdf>.

- Federal income tax law allows corporations to carryover net operating losses (NOLs). Such losses may be carried back for 2 years and forward for 20 years. Prior to 1998, the federal carryover periods were 3 back and 15 forward. California law is different: California does not allow NOLs to be carried back. For many years, only 50% of the NOLs could be carried forward and only for 5 years. Recent changes have increased that percentage to 60% and the carryforward period to 10 years. For tax years beginning in 2002 and 2003, California suspended use of an NOL carryforward, but extended the number of years in the carryforward period for the loss of the initial carryforward years. Beginning in 2004, new NOLs may be carried forward at 100% (rather than 60%). “New businesses” may carryforward 100% of their NOLs, but only for the first 3 years.
- To address taxation by the states of the income of multistate businesses, in 1959, Congress exercised its authority under the Commerce Clause by enacting Public Law 86-272 (15 U.S.C. §381). This law provides the minimum standards that must be met for a state to impose a net income tax on the operations of a remote vendor with respect to sales of tangible personal property. This law prohibits a state from taxing a foreign (out-of-state) corporation's net income derived from activities within the state if those activities consist merely of solicitation of orders for the sale of tangible personal property that are approved, filled, and shipped from outside the state. Issues have arisen over the years as to what activities fall within "solicitation of orders" and what constitutes an income tax.⁷²

In 1967, soon after enactment of P.L. 86-272, the Multistate Tax Compact was created and adopted by most states. The Compact serves to facilitate equitable apportionment of the income tax base among jurisdictions, to promote uniformity of rules among the states and to avoid double taxation. California is a member of the Compact. The Compact contains the Uniform Division of Income for Tax Purposes Act (UDITPA), which provides uniform rules for apportioning income for state income tax purposes.⁷³ California adopted UDITPA in 1966.⁷⁴

- Nexus Issues (when P.L. 86-272 does not apply):

Court decisions dealing with intangibles:

- 1) In the past several years, there have been issues (primarily outside of California) on whether intangibles create nexus such that the state may impose tax obligations upon the vendor. For example, in *Geoffrey, Inc. v South Carolina Tax Commission*, 437 S.E.2d 13 (S.C. 1993) *cert. denied* 510 U.S. 992 (1993), Geoffrey (G), a Delaware holding company executed a license agreement allowing Toys R Us (T) to use its trademarks, trade names, merchandising skills, and know-how to market, promote, market and sell products. G received a royalty equal to 1% of net sales. T did business in

⁷² For more information on California's interpretation of P.L. 86-272, see FTB Publication 1050 available at <http://www.ftb.ca.gov/forms/misc/1050.pdf>.

⁷³ The UDITPA tax allocation system was approved in 1957 by the National Conference of Commissioners on Uniform State Laws and by the American Bar Association. See 7A U. L. A. 91 (1978).

⁷⁴ The rules can be found at R&T §§25120 through 25139.

South Carolina (SC) and deducted the royalty it paid to G in computing its SC taxable income. SC held that G was required to pay the SC corporate license fee because of the presence of its license in SC, which G challenged. The court held that G had the minimum connection with SC to be subject to tax there without a due process problem. "We reject Geoffrey's claim that its intangible assets are located exclusively in Delaware. Accordingly, we find that Geoffrey's purposeful direction of activity toward South Carolina as well as its possessing intangible property here provide a definite link between South Carolina and the income derived by Geoffrey from the use of its trademarks and trade names in this State." The court also found that under SC law, G's royalty income would not be allocated or apportioned to Delaware.

- 2) In *Kmart Properties, Inc. v. Taxation and Revenue Dept.*, No. 21, 140 (N.M. Ct. App, 11/30/01), use of a subsidiary's (KPI) trademark by the parent corporation (K Mart) was found to establish nexus and tax obligations in N.M. for KPI. In the Due Process analysis, the judge found that KPI purposefully directed its efforts towards N.M. residents and availed itself of N.M. markets by licensing its trademarks to Kmart in N.M. With respect to the Commerce Clause, the trial judge stated: "I have little difficulty determining that the contractual relationship between KPI and Kmart under the License Agreement creates the requisite physical presence required to subject KPI to New Mexico's taxing jurisdiction under the Commerce Clause. As noted in the Court's discussion in *Scripto* [362 U.S. 208 (1960)], the fact that KPI does not use its own employees to utilize its trademarks to generate sales to New Mexico residents, to enhance the associated value of its trademarks by utilizing them as a marketing tool, and to generate a stream of royalty income for itself should not be given constitutional significance. The License Agreement, with its attendant obligations upon Kmart to protect and enhance the value of KPI's trademarks, creates a contractual relationship between the parties in which Kmart uses the trademarks and their associated goodwill as a marketing tool to continuously solicit New Mexico residents to purchase merchandise associated with the trademarks, thereby creating the very income stream New Mexico seeks to tax. Kmart's relationship to KPI, particularly in light of the requirements of trademark law which render the trademarks inseparable from the goodwill of the business they are associated with, places Kmart in the same position as the salesmen in *Scripto* and the independent salesmen in *Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue*, 483 U.S. 232, 107 S.Ct. 2810 (1987). Kmart is contractually obligated to do the very things which establish, maintain and enhance the market for KPI's trademarks in New Mexico in order to generate a revenue stream for KPI derived from those marketing activities. These contractual obligations give KPI a presence in New Mexico which goes far beyond those of *Bellas Hess* and *Quill Corporation*, whose only contacts with the taxing states were by mail and common carrier." [footnote omitted]

The decision was upheld on appeal to the New Mexico Court of Appeals. That court also noted that the physical presence requirement laid out by the U.S. Supreme Court with respect to sales and use taxes in the *Quill* decision

did not apply to income tax cases. The court also noted that its holding did not mean that Kmart or any of its employees were the agent of KPI. For purposes of establishing Commerce Clause nexus, the representatives creating nexus need not have legal authority to bind the taxpayer.

Proposals:

- 1) The Multistate Tax Commission (MTC) issued a draft proposal in 2002 to determine when a company has nexus for business activity taxes. The proposal – referred to as a “factor presence nexus standard” states that a company that is organized or commercially domiciled in a state has substantial nexus in that state. In addition, if during a tax period, a company has either (a) \$50,000 of property, (b) \$50,000 of payroll, (c) \$500,000 of sales or (d) 25% of total property, payroll or sales in the state, it has substantial nexus in the state. The MTC approved the draft on October 17, 2002 with California abstaining.
- 2) S. 664 (107th Congress) - the "New Economy Tax Fairness Act" or NET FAIR Act proposes that no state may assert any business activity tax or impose sales and use tax collection obligations on a vendor that does not have a "substantial physical presence" in the State. The bill provides a list of activities which do not constitute a substantial physical presence. The list of "protected" activities includes solicitation of orders by the vendor or the vendor's representative for the sale of tangible or intangible personal property or services if the orders are approved or rejected outside of the state and approved orders are filled by delivery from a point outside of the State, presence or use of intangibles (such as trademarks or electronic signals or web pages) in the state, use of a web site, and use of an unaffiliated contractor in the state to perform warranty or repair work on property sold by a vendor located outside of the State. The "protections" do not apply to a vendor incorporated in the state or any individual domiciled or a resident of the State. An agency relationship may constitute a "substantial physical presence" in the State. An agency relationship only exists if it "(1) results from the consent by both persons that one person act on behalf and subject to the control of the other; and (2) relates to the activities of the person within the State." The provision is effective upon enactment and so will not invalidate collection of any business activity tax imposed prior to that date (even though it violates one of the "protections"). If a vendor terminates its "substantial physical presence" in the State, the State can no longer after that point impose an obligation to pay a business activity tax or to collect and remit a sales or use tax upon the vendor.
- 3) H.R. 3220 (108th Congress) – the Business Activity Tax Simplification Act of 2003 would modify P.L. 86-272 so it no longer applied only to sale of tangible personal property, but to any property. It would also expand its scope to apply to all “business activity taxes” rather than only to income taxes. Business activity taxes do not include transaction taxes. The standard for determining whether a business has nexus in the state, apparently when P.L.

86-272 as amended does not apply, is the physical presence standard. This standard is defined as follows. "A person has a physical presence in a State only if such person's business activities within such State include any of the following during the person's taxable year:

(1) Being an individual physically within the State, or assigning one or more employees to be in such State, on more than 21 days. However, the following shall be disregarded in determining whether such 21-day limit has been exceeded:

(A) Activities in connection with a possible purchase of goods or services for the business.

(B) Gathering news and covering events for print, broadcast, or other distribution through the media.

(C) Meeting government officials for purposes other than selling goods or services.

(D) Participation in educational or training conferences, seminars or other similar functions.

(E) Participating in charitable activities.

(2) Using the services of another person, except an employee, in such State, on more than 21 days to establish or maintain the market in that State, unless that other person performs similar functions on behalf of at least one additional business entity during the taxable year.

(3) The leasing or owning of tangible personal property or real property in such State on more than 21 days. However, the following shall be disregarded in determining whether such 21-day limit has been exceeded:

(A) Tangible property located in the State for purposes of being assembled, manufactured, processed, or tested by another person for the benefit of the owner or lessee, or used to furnish a service to the owner or lessee by another person.

(B) Marketing or promotional materials distributed in a State using mail or a common carrier, or as inserts in or components of publications.

(C) Any property to the extent used ancillary to an activity excluded from the computation of the 21-day period under paragraph (1) or (2)."

- Corporations that are "unitary," meaning that there is a connection between the in- and out-of-state activities, must combine their income before determining the amount apportionable to California (combined reporting). Businesses are unitary if they are highly interdependent, such as having centralized decision-making, purchasing, marketing, or accounting. The unitary approach is not an objective one and can cause some confusion for taxpayers as to whether their businesses are unitary. Combined reporting is not the same concept as consolidated returns that

some related corporations use to determine federal income tax liability. For more information see Form 100, Schedule R and FTB Pub. 1061.

- Corporations doing business within and outside of California will need to apportion their business income. Corporations apportion their business income to California using a double-weighted sales factor along with single weighted property and payroll factors. Corporations in banking, savings and loan, agriculture or extractive industries are not subject to the double-weighting requirement for the sales factor. Non-business income from intangible property is allocated to the state of commercial domicile. Non-business income from tangible property is allocated to the state where the property is located.

As provided in UDITPA, the property factor in California includes only the value of real and tangible personal property; intangible property is excluded. Property that produces non-business income is also excluded. Property is valued using its original cost for federal depreciation purposes, but without any adjustment for depreciation. The cost basis is increased for any capital improvements. Rented property is included in the property factor at eight times the annual rental rate.

The numerator of the payroll factor is total compensation paid in California to produce business income. The denominator is compensation paid everywhere to produce business income. Payments made to independent contractors are excluded.

The sales factor consists of gross receipts from business income including interest income and carrying charges. Sales from transfers of intangible property or services are apportioned to California if the income-producing activity is performed entirely in California. When the income-producing activity involving intangibles takes place both in and outside of California, the “all or nothing” approach is used. If the income-producing activity is performed in California and elsewhere, but a larger portion of that activity is performed in California (based on the costs of performance) all receipts are allocated to California. If a larger portion of the income-producing activity is performed outside of California, none of the gross receipts are allocated to California. In measuring costs of performance, only direct costs are considered. While gross receipts from licensing of intangibles are included in the sales factor, the intangible is not included in the property factor.

- Various tax credits are available to businesses. In 2000, corporations (including S corporations) used almost \$1.2 billion of tax credits. This was a 33% increase over 1999.⁷⁵ Significant credit amounts claimed in 2000 were:

Research	\$564 million
Manufacturer's investment	\$410 million
Enterprise zone	\$103 million
Prior year AMT	\$ 51 million

⁷⁵ Franchise Tax Board, *supra*, page 29.

In 2000, 9,101 of 497,844 corporate returns claimed some type of tax credit. The total credits claimed totaled \$1,180,642,000 that reduced aggregate state tax liabilities of \$6,968,515,000.⁷⁶

The Manufacturer's Investment Credit (MIC) expires at the end of 2003 because the job increase needed to maintain it as part of the law was not met. Efforts to renew it failed to pass in the 2003 legislative session.

There is some perception that incentives created by the legislature are reduced by actions of the Franchise Tax Board. For example, in testimony presented to the California Commission on Tax Policy in the New Economy, an accountant noted that some FTB regulations reduce the scope of the manufacturer's investment credit (MIC), such as by providing a limited definition of qualified property.⁷⁷ Some rulings by the State Board of Equalization that have overturned decisions and legal rulings of the Franchise Tax Board also support this perception. For example, in *In the Matter of the Appeal of California Steel Industries, Inc.*, 2003-SBE-001-A; 160703 (SBE 7/03), the SBE held that contrary to the FTB decision and published FTB rulings. The SBE stated: "as we have previously stated, underlying our approach to the MIC is our belief that the MIC should be interpreted liberally in favor of taxpayers. (*Appeal of Save Mart Supermarkets & Subsidiary*, 2002-SBE-002, Feb. 6, 2002)" The SBE found that regulations and rulings issued by the FTB interpreted the legislature's definition of qualified property too strictly, for example, by requiring costs incurred by contractors to be split between qualifying direct labor and non-qualifying indirect labor.

- In 2000, corporations reporting loss, profit or none broke down as follows (state net income taxable in California):⁷⁸

Net loss	35.1%
No income or loss	6.4%
\$1 - \$19,999	27.3%
\$20,000 - \$99,999	18.8%
\$100,000 - \$499,999	8.9%
\$500,000 - \$9,999,999	3.2%
\$10 million or more	0.2%

- Number of corporations reporting income, loss or neither:

Year	Reporting income	Reporting loss	Reporting neither
1946	53.4%	19.7%	26.9%
1955	53.6%	25.0%	21.4%

⁷⁶ Franchise Tax Board, *supra*, page 147.

⁷⁷ See testimony of H [Matt Stolte, PriceWaterhouseCoopers LLP](#), March 20, 2002; available at commerce.ca.gov/state/tca/tca_navigation.jsp?path=California%2527s+Economy&childPath=Tax+Commission.

⁷⁸ Franchise Tax Board, *supra*, page 142. Data likely includes all corporations, not just C corporations.

1965	58.4%	29.1%	12.5%
1975	59.8%	30.4%	9.8%
1985	53.4%	35.9%	10.7%
1990	51.6%	37.6%	10.8%
1995	57.3%	37.1%	5.6%
2000	58.5%	35.1%	6.4%

- Corporations reporting net income – percentage of tax paid to net income reported in aggregate:⁷⁹

Year	%	Corporate tax rate	Minimum tax
1950	4.3%	4.0%	\$25
1955	4.4%	4.0%	\$25
1965	5.9%	5.5%	\$100
1975	9.3%	9.0%	\$200
1985	9.6%	9.6%	\$200
1995	6.7%	9.3%	\$800
2000	5.3%	8.84%	\$800

- In the past several years, concerns have been raised, primarily by the IRS, regarding the use of abusive tax shelters by corporations. To the extent that such investments or activities are found not to have economic substance for federal income tax purposes, the same would apply to state income tax purposes. The extent of the problem on the reporting of California corporate income tax is not clear. Tax shelters of relevance at the state level, but not at the federal level can exist in actions taken to move operations or property to other states to reduce state income taxes (such as moving intellectual property into a separate corporation in a state that does not tax income from IP). While this type of sheltering activity is not necessarily abusive, concerns exist by tax agencies that the actions are taken solely for tax purposes (court decisions vary on the validity of these transactions). The definition of an abusive tax shelter is subject to debate. Efforts have been made to define this term by the Treasury and IRS. The American Institute of CPAs (AICPA) has also weighed in on the issue and issued a suggested definition in April 2003.⁸⁰

In July 2003, the Multistate Tax Commission (MTC) released a report on the possible loss of corporate income tax revenue due to tax shelter activity for each state. The estimate for California was largest in terms of dollar amount - \$1.3 billion for fiscal year 2001, representing 19% of corporate income tax revenues. Percentage losses

⁷⁹ *Id* plus pages 67 – 68.

⁸⁰ See <http://www.aicpa.org/members/div/tax/shelters.asp> and http://www.aicpa.org/members/div/tax/shelters_qa.asp.

were highest in West Virginia (57.8%) and lowest in Michigan (10.3%).⁸¹

AB 1601 and SB 614, both enacted in October 2003 (Chapters 654 and 656, respectively), provide modified conformity with federal tax law by increasing penalties on certain tax avoidance and abusive tax shelter transactions. The new rules also codify the economic substance doctrine which is a judicial doctrine mostly explained in federal tax decisions.

- In 2001, corporate income tax collections represented 7.3% of general fund revenues while the personal income tax (PIT) represented 57.4%.⁸² In 1993, these percentages were 12.5% for the corporate tax and 43.9% for the PIT.⁸³ In 1997, these percentages were 11.2% for corporations and 48.3% for the PIT.⁸⁴
- Corporate income tax rate range for 2002 – selected states:⁸⁵

State	Tax rate	# brackets
Arizona	6.968%	1
California	8.84%	1
Colorado	4.63%	1
Massachusetts	9.5%	1
New York	7.5%	1
Oregon	6.6%	1
Virginia	6.0%	1

- 2001 corporate income tax collection as a percentage of total tax collections – selected states:⁸⁶

Arizona	6.4%
California	7.6%
Colorado	4.5%
Massachusetts	7.0%
Michigan	9.4%
New York	7.1%
Oregon	5.5%
Virginia	2.8%
All States Average	5.7%

⁸¹ Multistate Tax Commission, *Corporate Tax Sheltering and the Impact on Corporate Income Tax Revenue Collections*, July 15, 2003, available at <http://www.mtc.gov/TaxShelterRpt.pdf>.

⁸² Franchise Tax Board, *supra*, page 8.

⁸³ Franchise Tax Board, *1994 Annual Report*; available at <http://www.ftb.ca.gov/other/annrpt/1994/intro1.html#intro03>.

⁸⁴ Franchise Tax Board, *1997 Annual Report*; available at <http://www.ftb.ca.gov/other/annrpt/1997/intro.html#tblgfr>.

⁸⁵ Federation of Tax Administrators; table at http://www.taxadmin.org/fta/rate/ind_inc.html.

⁸⁶ Federation of Tax Administrators; table at <http://www.taxadmin.org/fta/rate/01taxdis.html>.

- Comparisons to Other States⁸⁷ – Per the LAO: “California's basic BCT rate of 8.84 percent is relatively high compared to other states (see accompanying figure). However, in making interstate tax-burden comparisons, one also must take account of more than just the tax rate--such as the various TEPs [tax expenditure programs, such as exemptions, deductions and credits] taxpayers benefit from. One way to adjust for this is by looking at corporate income taxes relative to personal income. In this regard, California's BCT burden is a bit above average for the U.S. as a whole (0.7 percent versus 0.5 percent).”

Comparison of Key BCT Provisions 1999 Tax Year

State	Tax Rate (%)	General Minimum Tax	S Corporation Taxability
Pennsylvania	9.99%	--	Exempt
Massachusetts	9.50	\$456	Exempt
New Jersey	9.00	\$250	Taxable
California	8.84	\$800	Taxable
New York	8.50	\$100 – \$1,500	Taxable
Arizona	8.00	\$50	Exempt
Wisconsin	7.90	--	Exempt
North Carolina	7.50	--	Exempt
Oregon	6.60	\$10	Exempt
Ohio	5.10 – 8.50	\$50	Exempt
Utah	5.00	\$100	Exempt
Illinois	4.80	--	Taxable
Michigan	2.20	--	Taxable

“The BCT's Future - The BCT's relatively subdued growth performance in California throughout much of the 1990s also occurred nationally and raises questions regarding the BCT's future role as a major revenue source. While BCT growth occurred in the most recent two years, its flatness in prior years during which the economy performed well remains a concern. For example, between 1994-95 and 1998-99 BCT revenues were basically stagnant even though overall economic growth was strong. This pattern is not fully understood, but some tax experts have pointed to increased use of creative corporate accounting and tax shelters--activities that could continue to constrain growth in the future.

⁸⁷ Legislative Analyst's Office, *California's Tax System – A Primer*, January 2001; available at http://www.lao.ca.gov/2001/tax_primer/0101_taxprimer_chapter4.html.

Future BCT growth also could be affected by the substantial overhang of previously generated, but as yet unclaimed NOLs. Although the magnitude of NOLs has declined recently, they still total almost \$70 billion, and are worth a potential tax savings of approximately \$6 billion to California corporations (and thus, revenue losses to the state), if and when used.”

■

- Issue analysis from the Legislative Analyst’s Office:⁸⁸

“Key BCT issues involve:

- *Income Apportionment.* Does California's use of a double-weighted sales factor in its income apportionment formula best achieve the state's tax policy goals?
- *Dividend Taxation.* California (like the federal government) "double-taxes" dividend income, since it is taxed under both the PIT and BCT. Should this be changed?
- *Integration.* More generally, since both the PIT and BCT tax income, some have proposed integrating the two taxes in some fashion. Should this be considered?
- *Federal Conformity.* California conforms to federal BCT law in many areas. Is California's policy of generally conforming still appropriate, and should additional conformity occur where it does not currently exist (such as with depreciation)?
- *Tax Expenditure Programs.* Are certain BCT-related TEPs ineffective or inefficient and, therefore, deserving of elimination or modification?
- *Revenue Performance.* Given the BCT's relatively subdued growth performance in the recent past, what will its growth be and are there associated problems with how the tax is being administered and enforced?”

⁸⁸ *California’s Tax System – A Primer, supra.*